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Timing and Sequencing of Trade Liberalization in Developing Countries — *Martin Wolf*

Trade Liberalization and Economic Growth in Europe and the United States — *Herbert Giersch*

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A Note from the Editor

The *Asian Development Review* was launched in 1983 as a part of the Asian Development Bank's effort to play a more broadly based development role in the Asian and Pacific region. In continuing this endeavor, the *Review* will, from time to time, focus on a topic of interest to the region.

This issue of the *Review* is the first in this series and the theme is trade liberalization and development. The recent establishment of a framework for a new round of trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT) reaffirms the growing economic interdependence among nations. Some countries in the region have achieved impressive economic progress mainly through their ability to expand trade, while the changing economic environment calls into question the ability of other developing countries to follow this path of growth. These considerations, together with the new round of GATT negotiations beginning to address the issues raised by recent economic developments, give trade policy and experience a special relevance to this region.

It is hoped that the articles in this *Review* will help provide deeper insights into trade relationships among countries within and outside the region and encourage further study and wider discussion on trade and development.

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Timing and Sequencing of Trade Liberalization in Developing Countries

Martin Wolf*

There is surprisingly general agreement, not only among academics and international institutions but also among those responsible for policy-making in developing countries, that it would be desirable to achieve a considerable measure of trade liberalization. A large body of empirical evidence has convinced most of those whose minds are not entirely closed on the subject of the positive relation between trade policy and economic growth. While many questions remain open for debate — for example, whether it is *neutrality* between the incentive to export and to produce import substitutes or the more stringent requirement of more or less complete *liberalization* of imports that matters — it is now quite widely agreed that something needs to be done to improve the rationality of the trade regimes of many developing countries.

The fact that this view is held with strong conviction reflects the observation that the needed changes are not, for the most part, a matter of fine tuning at the margin. The trade regimes of the great majority of developing countries are byzantine in their complexity, with import restrictions piling on tariffs that are not only highly variable but often go well over 100 per cent and with exchange controls piled on top of those import restrictions, like Pelion on Ossa in the ancient Greek myth. Research has demonstrated that the resulting pattern of incentives for the allocation (or, more precisely, misallocation) of resources is rather the haphazard by-product than the intended consequence of such hectic intervention.

While there is substantial agreement on the goal of trade liberalization, there is, unfortunately, much less agreement on how to achieve it. Both at the level of theory and at that of empirical research the question of how best to make the transition from one set of policies to another is intractable. Accordingly, the present discussion can provide no more than an indication of the issues that arise, with little claim to the sort of scientific precision that can be discerned either in such classic elements of the theory of international trade as the idea of comparative advantage or even in the research on the relation between trade regimes and economic growth.

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* Director of Studies, Trade Policy Research Centre, London. The views expressed in this article are based in large part on the author's participation as a member of the external panel of the World Bank comparative country studies research project on timing and sequencing of a trade liberalization policy (673-31). They are also based on his direction of a research project of the Trade Policy Research Centre on the participation of developing countries in the international trading system. The views expressed are his own and do not necessarily reflect those of the World Bank or the staff and Council of the Trade Policy Research Centre.

The discussion below starts with a consideration of why it is so difficult to reach any precise, scientifically based conclusions on the issue, for that is itself a matter of some importance. The first section explains how the question of the timing and sequencing of trade liberalization is to be approached. The second looks at the conditions in which the liberalization process usually starts, conditions that are often characterized by a major stabilization and foreign exchange crisis that is both cause and, to a certain extent consequence, of a distorted and highly restrictive trade policy regime. The third examines the problem of trade liberalization during such a stabilization crisis, especially, the appropriate balance between changes in macroeconomic policy, in exchange rates and in trade policy itself. The fourth section deals with the design of trade liberalization for a country that is not suffering from a stabilization crisis, the focus being on the credibility of the liberalization process, on the role of pre-announcement and its relationship to unilateral or multilaterally agreed liberalization, and on the costs of adjustment. Finally, some of the main lessons and most significant difficulties are outlined in the last section.

Reasons for Ignorance

Why is it so difficult to provide any general solution to the problem of how best to time and sequence trade liberalization? This is a very important question, the correct answer to which will also illuminate the nature of the policy problem actually faced by the liberalizing government.

Costs of Economic Adjustment

The costs of trade liberalization depend essentially on the costs of the associated adjustments. Theoretical analysis of the problem of adjustment has indicated that the *existence* of these costs result from market imperfections. The *scale* of the costs, however, depends on the precise structure of the various industries and firms affected by the process of trade liberalization, on the quality of entrepreneurship, and on the extent of the required adjustments. To illustrate the last point: Will many industries have to disappear entirely or will relatively small changes in industrial structure and product specialization permit the survival of most existing activity?

Since liberalization usually involves a much more than marginal change in the economic structure, the knowledge of what should and would follow is incomplete even in the best of circumstances. The required knowledge of the existing industrial structure and effects of prevailing market distortions is likely to be deficient. Accordingly, the scale of the adjustment costs to be anticipated is to a considerable extent unknown, *even if one ignores the influence on adjustment costs of expectations about the durability and extent of the process of liberalization.*

But one cannot ignore these expectations. Both the entrepreneurial alertness that leads to exploitation of new opportunities and the willingness to contemplate either changes in wages and prices or movement of factors of production from one line of business to another are dependent on the credibility and transparency of the policy of liberalization itself. A government is not operating on an unreflecting economic machine. Economic agents interpret the world in which they find themselves, the policy environment being an important part of what they have to interpret. The costs associated with a radical change in policy are particularly sensitive to the perception of economic agents about the permanence and significance of that policy. The less credible a policy the higher the economic costs tend to become before economic agents are convinced of the necessity to make the required changes in their activities and behavior.

In short, what are usually thought of as strictly economic costs are themselves determined by judgments of economic agents about the political process. A corollary is that the more an economy needs to liberalize (because the more pervasive the policy-induced economic distortions) the higher the costs of doing so are likely to prove (because the less credible any announced change of policy would be, given what has probably been a long history both of protection and of failed attempts at liberalization). The general point is that the market imperfections that determine the costs of adjustment are endogenous to the liberalization process itself, and this makes it vastly more difficult to predict those costs.

Political Aspects of Liberalization

Furthermore, the political process, too, is endogenous, as has been shown by the copious work on the political economy of protection. Any announcement of a program of trade liberalization is likely to lead to lobbying by those adversely affected. A belief that adjustment costs will be high will trigger particularly vigorous lobbying behavior, which will, in turn, affect the credibility of the liberalization program and so render self-fulfilling the initial belief that adjustment costs will be high.

There is certainly little precise knowledge of the probability of success of any particular lobbying effort, which is, in any case, bound to depend on the particular characteristics of the country concerned. It is, therefore, impossible for anyone to predict with certainty whether any given program will be executed. In view of the difficulty of predicting the way the political process will come out, the choice of an adjustment path that minimizes adjustment costs can hardly be made scientifically, certainly not without a fully worked out model of the politics of the process, which are themselves endogenous.

In short, liberalization is a complex game played between government and society (as is, indeed, true of much economic policy). It should never be analyzed as if government were manipulating the actions of Pavlovian dogs, the problem being only that of choosing the right stimuli for optimal canine performance.

Paucity of Successful Exemplars

Apart from these difficulties in principle, it is also necessary to stress the problem facing empirical research. There are very few cases of successful liberalization, defined here as a large change in the degree of protection, which ends at a highly liberal end-point and is sustained over a long period, probably through changes in government, so indicating the existence of a political consensus in favor of liberalization. Leaving aside the developed countries, though they obviously represent an important set of cases, one can find few examples: Looking just at the cases studied in the World Bank's research project on the timing and sequencing of trade liberalization, one observes the following successful examples: Greece, Israel, Portugal and Spain in Southern Europe (though all these apparent successes can be qualified in certain ways, either because of the limited extent of liberalization actually achieved or because of powerful pressures to reverse it, as in Greece in the mid-1980s); the Republic of Korea and Singapore in Asia, to which can be added Taiwan, from outside the research project (though Singapore was never significantly protectionist, while the Republic of Korea and Taiwan still have quite a long way to go before achieving full liberalization); and Chile in Latin America (though Chile does not meet the political test as yet, it being far from evident that there exists a political consensus on the liberalization). This gives at most eight cases. Examination of eight cases can give insights, but cannot give precise recipes for successful liberalization.

Consideration of an Archetype

It would appear clear that, even in principle, there can be no generally applicable recipe for the optimal timing and sequencing of trade liberalization. Furthermore, in the case of any particular country, the knowledge required to design an optimal program is bound to be lacking, not only because of the paucity of successful examplars but, still more, because the appropriate design of such a program must be influenced by an understanding of the effects of its very existence on the behavior of economic agents.

In view of all these difficulties, the approach taken below is not to claim scientific precision, but rather to take a less rigorous approach in considering the kinds of problems faced by a government that has decided to undertake the liberalization of trade. The resulting dilemmas are described in terms of a "stylized" situation, one that reflects many, but certainly not all, of the features familiar from the history of many individual countries over the past 40 years or so. The liberalizing country that is discussed should, therefore, be viewed as an archetype, the discussion of whose problems may help to illuminate those of actual countries.

Initial Conditions

It is a fact of life, regrettable but quite understandable, that major changes in policy are usually born of crisis. Happy is the country that can contemplate a shift from a long-standing policy of protection to one of trade liberalization, starting from a situation of full employment, rapid economic growth, balance of payments equilibrium, and stable domestic prices. Happy indeed would be such a country, but it would also represent a strikingly rare case. No country is likely to enjoy such blessings if protection is already pervasive and, if it were in so fortunate a position, it would be unlikely to contemplate any major program of trade liberalization.

It is true that there are cases from recent history of countries with comfortable balance of payments positions, rapid growth and low unemployment that are also engaged in long-term processes of trade liberalization. Examples of such countries are Japan from the early 1960s onwards; Taiwan from somewhat later; and Greece, Israel, Singapore and Spain within the set of cases that are being studied by the World Bank's research project on the timing and sequencing of trade liberalization. In some of these cases, external pressure (Japan being the most obvious example) or treaty commitments to liberalize (such as an association agreement with the European Community) have played a role. In all of these cases, however, there appears to have been a prior economic stabilization. The *beginning* of the whole process was not in a time of comfort. The leisurely liberalization processes that one notices involve continued movement along a path on which the country had started previously. Momentum appears to have been carrying the country along. These cases show not so much a *change* in policy as a *confirmation* and *development* of an already existing liberalization process.

By contrast, the discussion below starts at the beginning, with the turning point, with a move from a strong commitment to protection to a willingness to contemplate liberalization. Normally, a crisis marks such a turning point. What, then, are the characteristics of such a crisis?

Public Sector Deficits and Their Finance

The principal reason that the trade policy problems of developing countries (and developed countries, too, sometimes) are so intractable is that they are frequently the symptom of commitments by government to expenditures that cannot be financed. The starting point is pressure for levels of expenditure that cannot be covered by tax revenues. The reasons for the inability to raise sufficient revenue are usually an amalgam of economic factors (developing countries having a limited taxable capacity and copious opportunities for tax evasion) and political factors (support for the government tending to crumble if a determined effort is made to levy taxes on politically powerful groups).

Deficits can be financed by borrowing, by printing money, or by a combination of the two. In most developing countries, domestic capital markets are undeveloped (frequently because of a long history of inflation and consequent financial repression). The capacity to borrow substantial sums at home is, therefore, soon exhausted. In certain circumstances, borrowing abroad is possible, as was, indeed, the case in the 1970s, when there appeared a plentiful supply of loanable funds from abroad at low or even negative real rates of interest. As with borrowing at home, however, the costs of external borrowing can become prohibitive if borrowing requirements grow more rapidly than the economy itself. An explosive growth of debt in relation to gross domestic product (GDP) will, sooner or later, undermine the creditworthiness of both the government and, if borrowing abroad is involved, the country.

Borrowing requirements are likely to grow particularly rapidly whenever the real rate of interest is close to, or — still worse — exceeds, the economy's real rate of growth of GDP. Furthermore, lenders know that the higher the ratio of debt to GDP the greater the costs (in terms of the required fiscal and trade surpluses) that a country will incur in attempting to stabilize that ratio whenever the real rate of interest exceeds the prospective rate of domestic economic growth. There will, therefore, be a limit to the ratio of debt to GDP that lenders will be prepared to finance, as soon as there is believed to be any possibility of the unfavorable combination of high real rates of interest in the world's capital markets and low rates of economic growth in the debtor country.[1] Because of the effects of a sudden curtailment of credit on the indebted economy, however, high real rates of interest are themselves likely to lower rates of domestic growth. Accordingly, any concern about the prospective level of world rates of interest will soon undermine what were previously thought to be viable levels and trends in ratios of debt to GDP, by leading to simultaneous upward adjustments in expected costs of borrowing and downward adjustments in expected rates of growth of GDP.

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[1] The condition for stability of the ratio of external debt to GDP is quite simple. It is, in general, that $dD/D \leq dY/Y$, where D is the stock of external debt and Y is GDP.

We assume, for simplicity, that the government is unable to borrow domestically (or has a fixed amount it can borrow domestically), that the private sector is self-sufficient in savings and that the government does not, at least initially, finance its deficit through the creation of money. In other words, the fiscal deficit is financed entirely abroad and only the public sector borrows abroad. These simplifying assumptions do not do fundamental violence to the economic processes involved.

Then: (1) $dD = B + rD$, where B = fiscal deficit, excluding debt interest; and r = the real rate of interest.
Then the debt to GDP ratio is stable if
(2) $B \leq D(\mathrm{g}\text{-}\mathrm{r})$ or
(3) $B/Y \leq [D(g\text{-}r)]/Y$, where g = the rate of growth of GDP.

Accordingly, whenever r is less than g the public sector can be in deficit and the debt to GDP ratio can still be stable. If, however, r were to exceed g, the fiscal deficit would have to be negative (that is, be in surplus) if the debt to GDP ratio were to be stable.

If, for example, r were 3 per cent a year and g 6 per cent (a highly satisfactory combination), the fiscal deficit (excluding the interest burden itself) needs to be equal to or less than 3 per cent of the stock of outstanding debt. In most developing countries, that stock is less than 50 per cent of GDP. This would imply that stability requires a fiscal deficit, excluding debt interest, of 1.5 per cent of GDP or less. The total fiscal deficit, including debt interest, could then be 3 per cent of GDP.

With higher debt to GDP ratios the fiscal deficit can be larger, while still maintaining stability in the ratio of debt to GDP, *so long as g exceeds r*. This does not mean — paradoxically — that the higher the stock of debt, the greater the permissible borrowing, for if r were ever to exceed g, the fiscal surplus would have to be larger for a country with higher ratios of debt to GDP than in one with a lower ratio of debt to GDP. To maintain stability with a D/Y of, say, 2 would then be much more difficult than with one of only 0.5. If r were to be 6 per cent and g 3 per cent, the fiscal surplus (excluding interest payments) would have to be 6 per cent of GDP, with a D/Y of 2 (the overall fiscal balance being a deficit of 6 per cent of GDP, with real interest payments due being no less than 12 per cent of GDP), but only 1.5 per cent of GDP with a D/Y of 0.5 (the overall fiscal balance being a deficit of 1.5 per cent of GDP, with interest payments being only 3 per cent of GDP). Lenders can reasonably doubt the ability of a government to achieve the needed surpluses. Accordingly, lenders are likely to be interested in whether it would prove politically feasible to maintain stability when the real rate of interest exceeds the prospective rate of economic growth. This concern will put a ceiling on the prospective ratio of debt to GDP.

A government that finds itself unable to borrow more abroad is nearly always driven to inflationary finance, usually in the form of borrowing from the central bank. In the long term, inflation is likely to accelerate. In the short term, however, goods and services can be obtained for attractively printed pieces of paper or entries in a bank ledger. If the money supply then grows more rapidly than nominal income, either inflation or a growing deficit in the current account of the balance of payments or, more probably, both together are sooner or later the inevitable result.

How quickly inflation rises depends on the extent of slack within the economy. With considerable slack much of the initial effect will be on levels of real output. How quickly the balance of payments responds to rising inflation depends on the elasticities of substitution between domestic and foreign goods or, more precisely, on the extent to which the "law of one price" holds in the short term. If the elasticities are high, the price level cannot rise very much in relation to prices abroad before pressure on the balance of payments becomes considerable. Even if the standard Keynesian assumption of highly elastic real output with respect to nominal demand were to hold, however, there would still be an adverse effect on the current account of the balance of payments if there were not both a real depreciation of the exchange rate and an associated policy to stimulate savings (or, in other words, to reverse or offset the initial source of excess demand).

Role of External Shocks

The trigger for such a crisis is often an external shock, an unanticipated reduction in the capacity to import (a deterioration in the commodity terms of trade) or to borrow (a deterioration in the intertemporal terms of trade in the form of higher real rates of interest). In both cases, there has been a loss of potential national income, to which some adjustment is necessary. The difficulty is that, while the private sector simply has to adjust if it has suffered such a loss of real income (with bankruptcy the ultimate sanction), this is not immediately true of the government. The government can try to postpone the adjustment by maintaining public expenditures in the face of a real loss of national income. It can try to shift the entire burden onto the private sector through higher taxes or it can finance its increased deficits either by borrowing or by printing money.

It is interesting to note that the early reaction of many developing countries, especially in Latin America, to the adverse shift in the commodity terms of trade after 1979 was to increase external borrowing, the principal aim being to sustain real levels of public expenditure. In this case, however, the deterioration in the commodity terms of trade turned out to be associated with a surprisingly sustained deterioration in the intertemporal terms of trade as well (in contrast to the situation after the first "oil shock" when real rates of interest declined). After a while, the high real cost of the borrowing strategy in these circumstances became obvious and further international borrowing ceased to be a viable way of filling the real resource gap after the summer of 1982. The response of most Latin American indebted countries to the higher real cost of international borrowing implicit in the debt crisis has, for the most part, been not so much to cut public expenditures as to raise taxes on the private sector directly and to resort to increased inflationary finance, so indirectly increasing the taxation of the private sector.

Suppression of the Symptoms

Faced, then, with rising inflation and a loss of foreign exchange reserves, some action is required of government. What would such action be? The right thing to do is to tackle the underlying problem, the unfinanceable commitments to public expenditure, but that is usually what government is least able to do, often in the interests of mere survival. One may suggest that a society becomes economically ungovernable when no government that attempts to take the steps needed to stabilize the economy can gain, or retain, the support needed to survive. Far from being a rare situation, this is quite common, especially in societies with both long histories and vigorous traditions of populist politics.

Governments face an overwhelming temptation to suppress the symptoms, with both price controls and import and exchange controls being the obvious means. Controls on prices of domestic output and controls on external transactions are often closely related because the most effective of all single instruments for control over prices is an exchange rate that moves more slowly than the difference between domestic and international inflation. With such an exchange rate policy, prices of tradable goods cannot rise as fast as those of goods and services in general, the result usually being a windfall improvement in the real incomes of factors involved in the production of non-tradable goods or, more precisely, factors that are relatively intensively used in their production, and this group usually includes labor. At the same time, the steady appreciation of the real exchange rate caused by such a policy greatly exacerbates the balance of payments problem and so increases the pressure to introduce and reinforce import and exchange controls.

Towards Economic Implosion

In the short term, controls usually "work", in the sense that they suppress the consequences of disequilibrium. It takes time for an economic system to adjust and, in any case, the producers of unprotected goods, especially exports, are increasingly taxed as the real rate of exchange continues to appreciate. Income is transferred to holders of import licenses, producers of import substitutes, wage earners in general (unless exports are relatively labor-intensive) and consumers (especially if exports are important wage goods). These transfers may reduce the pressure on government to sustain or increase the unfinanceable level of public expenditures. When transfers of income to import licensees and producers of capital-intensive import substitutes are significant, there may be an increase in the overall propensity to save, because these are groups likely to save a relatively high proportion of their income. Furthermore, the inflationary process itself can be an important source of taxation, especially in the early stages when holdings of money are large in proportion to GDP.

But this is far from the end of the story. Unless the effect on savings is considerable, import controls lead to a substantial shift of expenditures towards non-tradable goods and exportables. Prices of non-tradables then continue to rise, further worsening the profitability and shifting resources away from the production of unprotected tradable goods. Accordingly, with rising domestic demand for — and falling supply of — exportables, export earnings fall, at least in relation to trend, perhaps absolutely. With a shrinking supply of foreign exchange from exports, import controls have to be made still more restrictive.

Import controls usually start with supposedly non-essential consumer goods, but, as they are tightened, the supply of imported basic intermediates and capital goods starts to be curtailed. In most developing countries (all but the very largest), the inevitable result is a sharp decline in potential output.[2] Since the current account reflects the difference between national output and expenditures, declining output (in relation to trend or even absolutely) usually offsets the effects of whatever limited policies have been introduced to constrain expenditures, the result being that the balance of payments position gets still worse, despite the controls. The country concerned has thus embarked on a vicious downward spiral.

It is an important feature of this path that the incentives to produce different tradable goods diverge in often spectacular and entirely unplanned ways. Resources are pulled into producing import substitutes, especially the consumer goods labelled — paradoxically — too "inessential" to import, while exports are ever-increasingly taxed. These radical inefficiencies start to have significant effects on the rate of growth, a prime symptom often being steadily rising incremental capital/output ratios (ICORs). Evidence suggests that these differences in ICORs can become very large. Some of the fast growing developing economies of East Asia enjoyed ICORs of between 1 and 2 in the 1960s and early 1970s when India's ICOR, for example, was moving towards 5.

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[2] The effects on the larger economies can be a little different because it is usually possible for them to produce virtually all manufactured goods at less than infinite marginal cost. Accordingly, they are less likely to find that certain manufactured inputs are completely unavailable as supplies of foreign exchange decline and the constraint on growth is less rigidly binding.

In order to equilibrate the overall demand and supply for foreign exchange (namely, find an effective rate of exchange at which there can be internal and external balance) in the face of these radically increasing distortions in the conditions of foreign exchange supply, the effective price of foreign exchange (the overall weighted rate of exchange, taking into account the effect of protection on the price of importables) has to rise.[3] At the limit, when there is virtually no further possibility for import substitution, the equilibrium effective rate of exchange tends to infinitely high levels. Since such levels cannot be reached, equilibrium is unobtainable. The symptom of this condition is quite simply a collapsing economy combined with a balance of payments crisis, often exacerbated by the overhang of deadweight debt.

One important aspect of the deadweight debt is worth noting. Usually, well before the point of collapse has been reached, the need for a devaluation has become obvious. Accordingly, capital flight, whether through legal or illegal channels, becomes inevitable. Indeed, there is a strong incentive for owners of firms to borrow abroad, preferably with a public guarantee, and then place the proceeds abroad. One observer has described this as "selling one's country short while the international lenders take the long position".[4] This capital flight, which is an important part of what happened in Latin American countries such as Argentina and Mexico in the 1970s and early 1980s, exacerbates the underlying crisis and makes it far more difficult to solve when stabilization is finally undertaken, since the assets needed to service the debt are abroad and unavailable to the government. Such debt is deadweight, therefore, from the point of view of those responsible for the national economy. Equally deadweight is debt whose counterpart was consumption or even investment when those investments were profitable only because of the distorted prices created by protection.

Another feature of the path to the "imploding economy" is that it also tends to make the revenue problem progressively more serious because of what may best be described as the "bleeding" of tariff revenue. Most developing countries have cascading tariff structures, with the lower tariffs on capital goods and basic intermediates and higher tariffs on consumer goods. This alone tends to lower the average tariff on actual imports as imports of highly protected items decline. Import controls usually exacerbate the problem since the high tariff items are often banned altogether as "inessential", while the tariff equivalent of controls on lower tariff items is captured by licensees. For many developing countries, especially the smaller ones, tariffs are both an important and an easily collected source of revenue, a decline in which can greatly exacerbate the revenue problem whose balance of payments symptoms are being tackled by import controls. This is yet another of the vicious spirals on which a protectionist developing country can find itself.

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[3] The point can be put a little more precisely as follows: Assume that the nominal rate of exchange is given, that the prices of non-tradables are also given in nominal terms, and that the tariff is the sole device for adjusting the effective rate of exchange. Rises in the tariff will pull resources from exportables and non-tradables towards import substitutes while increasing demand for both of the former (as against protected importables). As the tariff level rises, the effect on the supply of foreign exchange through import substitution will become ever smaller, since there will be a movement towards the production of import substitutes at ever higher marginal cost. Part of that ever higher marginal cost will involve pulling resources from the production of exports, with ever more foreign exchange foregone from exports at the margin. At the same time, demand for imports is likely to become increasingly inelastic as the more readily substitutable imports are already produced at home and consumption of the more demand elastic imports has already fallen sharply.

A point will probably arise when further increases in the tariff produce neither further net increases in the supply of foreign exchange nor further reductions in the demand for it. If that tariff level does not generate a set of relative prices at which internal and external balance are feasible, no further increases in protection can bring it about. This situation will then be referred to — quite rightly — as one of "foreign exchange constraint". What will usually be ignored is that the foreign exchange constraint will have been created by the policies designed to remove it.

[4] I owe this telling phrase to Larry Sjaastad of the University of Chicago.

Stabilization and the Reduction of Anti-Export Bias

In a situation like the one described, it is virtually impossible to do nothing. On the contrary, it is necessary to do something rather quickly and that action needs to be sufficiently decisive to have: (i) a real prospect of improving the underlying situation; and (ii) a likelihood of changing the expectations of economic agents sufficiently to make possible further improvements in economic policy at moderate cost. The essential question is what *must* be done and how far preparations should be made to go further in the direction of trade liberalization that is desirable, rather than absolutely necessary, in the short term.[5]

Policy for Stabilization

The central element in any policy to improve the situation rests with macroeconomic policy or, more precisely, with public finance. While a temporary improvement in the balance of payments can be brought about by a large real depreciation of the exchange rate, such a depreciation will be eroded rapidly, with a further turn of the inflationary screw to boot, if the excess demand for resources being generated by the public sector continues. Moreover, it should be noted that there is excess demand in this situation, even if there are idle resources, since those idle resources reflect microeconomic distortions, especially in the incentive to produce and use foreign exchange. Expansionary policies in this situation would make (and probably already have made) the problem of unemployment of resources worse, not better, by stimulating inflation and so increasing the extent of overvaluation of the real rate of exchange.

The first and essential point is that management of the stabilization crisis and sustained liberalization of the trade regime thereafter cannot be achieved if the public sector deficit is not reduced to a level that can be financed in a non-inflationary way.

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[5] Considering the starting point for liberalization, one is reminded of the story of the tourist lost in the Irish countryside who asks a local for the directions to Dublin. After scratching his head, the local responds, depressingly, "Well, if I were you, I wouldn't start from here".

Real Exchange Rate and the Incentive to Export

The second issue is the problem of the anti-export bias that has inevitably arisen in the course of the events leading to the stabilization crisis. In the context of the widespread and substantial implicit quota premia generated by the exchange control regime, a substantial depreciation of the real exchange rate fortunately has the effect of reducing the anti-export bias and liberalizing the import control regime at the same time. The reason is that the rising price of tradable goods in terms of domestic currency directly affects exports (and import substitutes not covered by import controls). In the case of imports covered by binding import controls, however, the quota premia are first soaked up. It is only after those quota premia have disappeared that the domestic prices of the protected goods can be expected to rise. The consequence is that the devaluation per se can be expected to make the tariff, an instrument that works through prices in the market, more important. Furthermore, the greater the previous redundancy of tariffs and the larger the quota premia the more the devaluation itself can do to undo anti-export bias, because the premia to be soaked up are correspondingly larger.

It needs to be stressed how important the real exchange rate adjustment is likely to be. It is an almost inevitable characteristic of the initial situation that the stabilization program will be associated with recession, and this alone will tend to undermine the political acceptability of the policy change. By changing the real rate of exchange sufficiently rapidly, however, there will be improved demand for one important segment of output, namely, exportables and unprotected import substitutes. This, in turn, will have direct effects on the level of real output as well as indirect effects on output, as the supply of foreign exchange starts to improve. The significance of the direct offsetting effects will depend in part on the ratio of exports to GDP. In the case of a very closed economy that effect will be small, but for that very reason the indirect effects of improved availability of foreign exchange may be large.[6]

The second essential element in the policy package is a large real depreciation of the real rate of exchange.

Need for Decisive Action

The central element of a successful stabilization package is, then, a combination of a reduction in the public sector deficit and a large real depreciation of the exchange rate. This combination deals with the underlying source of the problem as well as remedying what is usually the grossest of all distortions in the "imploded economy", the taxation of exports. At the same time, by making the tariff more generally effective, as a result of soaking up quota premia, the ground is laid for subsequent liberalization of the tariff in the knowledge of what the structure of protection is. The need for greater knowledge of the protective structure is important, not only for the government itself in making its plans for subsequent liberalization, but also to enhance the effectiveness of any lobbies against protection. It is a normal characteristic of a control regime that nobody knows who is most protected. An increase in the "transparency" of the protective structure (as well as improvements in government revenue) can be assisted by the decision to auction quotas as well, as has happened in New Zealand in the 1980s.

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[6] By way of illustration, in 1984 exports of goods and services were 37 per cent of GDP in the case of the Republic of Korea and only 12 per cent in the case of Turkey (itself much higher than in previous years). See World Bank, *World Development Report 1986* (New York: Oxford University Press, 1986), Annex, World Development Indicators, Table 5. Evidently, a given rate of growth of exports will have a much smaller effect on demand in the case of Turkey than in that of the Republic of Korea, but by comparison Turkey has also been starved of imports, many of which are producer goods. Especially prior to economic reforms in the 1980s Turkish output was constrained by a lack of foreign exchange which even modest absolute increases in foreign exchange could do much to alleviate.

Success in solving stabilization crises has almost universally been the starting point of successful processes of liberalization, the cases of Greece and Israel in the early 1950s and Spain after 1959 all being salient examples from the World Bank's project on the timing and sequencing of trade liberalization. Moreover, for stabilization to work the optimal timing is fast. There are several reasons for action that is both decisive and speedy. First and most important, the crisis itself usually does not permit the luxury of delay. Second, there will be substantial opposition to the measures, and such opposition is best taken by surprise. Third, an anticipated devaluation will generate capital flight, which cannot usually be avoided, even with exchange controls, because of overinvoicing of imports, underinvoicing of exports, and blackmarket dealings in foreign exchange. Fourth, the government itself often needs to show quick results if it is to survive.

The third element in the stabilization package is speed of action.

Economic Dangers and Pitfalls

While all this sounds straightforward, it very evidently is not. Problems of some importance will arise. Three, in particular, are worth considering because they have brought many attempts at stabilization-cum-liberalization to grief. They are the questions of: (i) the revenue and expenditure impact of the policy of stabilization-cum-devaluation; (ii) the link between liberalization of trade and the capital account; and (iii) the effect of the package on the anti-export bias, if expenditures on export incentives are cut.

Fiscal Implications of Stabilization. The reduction in aggregate output normally associated with a stabilization program will itself tend to reduce government revenue and it may also lead to increased expenditures on social welfare and on subsidies to loss-making public and private enterprises. For this reason, too, it is important to achieve a real depreciation of the exchange rate in order to stimulate export industries and release foreign exchange constraints. In any case, public finances can be quite difficult to manage during the period of stabilization.

At the same time, the depreciation itself, especially when brought in at the same time as a tariff rationalization, can increase revenue and reduce some expenditures. In particular, the soaking up of license premia means that revenue is being transferred from import licensees to the government. At the same time, some reduction in explicit export incentives may occur with the depreciation. Both of these effects can be helpful to the government, the extent of the help depending largely on the openness of the economy. Large and relatively closed economies, such as India's or Brazil's, cannot generate much revenue from border taxes and are never likely to allocate a very large proportion of government expenditure to export incentives.

There is one respect in which the depreciation can greatly increase the public expenditure problem, and that is if the government has substantial net debt to lenders abroad, whether directly or indirectly (through guarantees). The consequence of depreciation is, then, a large increase in expenditures on debt service in domestic currency. A devaluation of 100 per cent would, for example, double debt-service payments in domestic currency. Furthermore, with such a devaluation many private borrowers who were previously subsidized in their international borrowing through the exchange rate overvaluation will be bankrupted, and the government will either be legally required or may be forced by external pressure (from lenders, for example) to assume their obligations. This, too, would increase the level of public expenditures.

Stabilization and the Capital Account. It is often argued that liberalization is impossible without an increased inflow of foreign exchange in the form of grants or loans. This is untrue of the package considered above, since liberalization, in the sense of reduction in the domestic price of any tradable good, does not occur, at least immediately. Furthermore, an increased inflow of foreign exchange can make the package unworkable unless the inflow is at least partly sterilized and put into reserves. The reason is that the real exchange rate will then tend to appreciate. With such an appreciation, the bias against exports in relation to import substitutes may fall, as quota premia for imports decline with increased availability of foreign exchange, but the incentive to produce tradables in general will also fall. The result is likely to be a damaging recession in the tradable goods sector over and above the recession associated with the stabilization policy per se.

When considering these problems, the cases of Sri Lanka, Chile and, above all, Argentina in the late 1970s and early 1980s come to mind. The latter case is worth careful attention because the experience was so extreme, embracing just about all possible errors. After 1976, the capital account in Argentina was liberalized before trade. At the same time, there continued to be high budget deficits. The financing of those budget deficits, combined with a tight monetary policy aimed at lowering inflation, led to high domestic real rates of interest. At the same time, the exchange rate policy was to depreciate at rates slower than needed to offset the inflation differential, in order to curb inflationary expectations. As a result, the real rate of exchange appreciated, the inevitable current account deficit being financed by borrowing from abroad.

Given the exchange rate policy, the high rates of interest in Argentina appeared to offer generous returns to foreign lenders, so encouraging the required capital inflow. Meanwhile, the cannier domestic residents took advantage of the opportunity created by the real appreciation of the exchange rate and the capital market liberalization to export capital. Notwithstanding this capital flight, the real exchange rate appreciated dramatically – by more than 100 per cent – and the consequent recession in the tradable goods producing industries made further substantial trade liberalization impossible. The policy as a whole ultimately collapsed, leaving behind a legacy of huge external public debts and a sizable stock of assets held privately abroad, the income from which was unavailable for debt service.

It is sometimes held that Argentina's experience proves that it is an error to liberalize the capital account before the current account, but this conclusion is not self-evident. What is striking about the experience is that it involves four distinct elements: (i) a failure to control the fiscal deficit; (ii) an exchange rate policy bound to create an ever-appreciating real rate of exchange; (iii) freedom of capital inflow; and (iv) freedom of capital outflow. The first of these contributed to the high rates of interest, while making the counter-inflationary strategy ultimately unworkable. The second created a distortion in the relative prices of tradables and non-tradables as well as a huge incentive for capital flight. The third allowed capital inflow from those lenders that thought themselves guaranteed against the major risks, in order to take advantage of the high expected real rates of interest. And the last allowed uncontrolled capital flight. All of these elements together created a disaster.

That stabilization is impossible without control of the fiscal deficit is already clear. The appreciation of the real rate of exchange that is afforded by free inflow of capital and is motivated by counter-inflationary policy does look to be economically lethal, as was also shown by experience in Chile, whose painful experience at the end of the 1970s and early 1980s shared just these two of Argentina's four characteristics. The whole adjustment process is thwarted by the real appreciation of the rate of exchange. The hoped-for new activities to produce tradable goods and services are usually not in a position to exploit long-run prospects when suffering from so dramatic a squeeze on profitability in the short term. Exchange rate appreciation should, therefore, not be used as the principal instrument of counter-inflationary policy.

So far as the capital account is concerned the danger would seem to arise more from the inflow than the outflow, since it is the inflow that permits the damaging appreciation of the real rate of exchange.[7] Indeed, with floating rates of exchange freedom of capital outflow would actually appear to be helpful since it would tend to drive down the real rate of exchange, as is desirable. If the capital account is to be liberalized, therefore, it would seem advisable (contrary to standard views) to start with the outflow, while limiting the inflow, especially if a tight counter-inflationary monetary policy is leading to high real rates of interest. The greatest danger with freedom of capital outflow arises if policy is already leading to a large appreciation of the real rate of exchange, for then capital flight becomes more or less inevitable and, in that context, the inflow is likely to create subsequent debt servicing problems if the obligations have to be honored. Freedom of capital outflow is, therefore, not so much a problem on its own as a source of additional problems in the context of the other errors: continued budget deficits and a real appreciation of the exchange rate driven by surging capital inflows.

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[7] There is also a welfare-theoretic proposition that freedom of capital inflow can be immiserizing in the context of the distorted relative prices for goods and services created by protection.

Devaluation and Anti-Export Bias. A third and quite distinct difficulty relates to policy towards exports. Before the crisis has arisen, the deteriorating performance of exports has already been obvious. In many cases, the response is to introduce a chaotic plethora of export incentives. These are often inefficient, but they do go some way to reduce the bias against exports. It is a frequent concomitant of devaluations that all these incentives are swept away, one reason being that they have themselves made an important contribution to the budget deficit that has to be reduced. Such a reduction may well be desirable, but the implications must not be ignored. The devaluation itself must be judged on a net basis, taking into account the loss of these incentives. There have been many cases in which devaluation was associated with an *increase* in the bias against exports because of the withdrawal of export incentives (Greece having such an experience in 1953 and Israel in 1962). Governments have sometimes even concluded from subsequent experience that exports do not respond to incentives.

The question of what to do about export incentives is quite a difficult one. There are public finance reasons for reducing them. Furthermore, the present position of the United States on countervailing duties is one that should at the least encourage caution in the use of explicit subsidies for exports. Many developing countries have had countervailing duties imposed on subsidized exports. At the same time, if the country has high tariffs there will still be a strong anti-export bias even if controls do become redundant after devaluation. In this situation, it may be necessary either to maintain (or even increase) explicit export incentives, lower tariffs, or do both, even during the stabilization phase.

Political Dangers and Pitfalls

It is an inevitable feature of the long history of controls that has preceded a crisis that a host of vested interests has emerged. Among the more important are the government bureaucrats who enjoy the power and opportunities for corruption created by controls, the importers who obtain the import licenses, the producers of highly protected import substitutes, the borrowers of foreign exchange at an appreciated real exchange rate (which almost always includes the government itself), the beneficiaries of the excessive public expenditures, and the consumers of exportables. Even the relatively limited reform program considered above will deprive many of these groups of the wealth and perquisites to which they have become accustomed. In certain cases, bankruptcy will result. The longer the import substitution program has been in being the larger the group that benefits. Such domestic interests may be particularly forceful in large countries used to thinking that trade is relatively unimportant. Governments will need courage or, at least, desperation before they contemplate offending so many important vested interests.

One of the more interesting features of the change in policy is the effect on rent-seeking behavior. Investment in lobbying will be a function of the size of the reward and the probability of success. Unfortunately, the mere announcement of a change in policy increases the incentive and probably does little to modify the chances of success. Accordingly, the waste of resources in lobbying is unlikely to diminish during a major stabilization episode and could well increase, at least until the policy is seen to be irreversible.

To help the government against the lobbies, it is particularly important that there be gainers fairly quickly. This is one reason for a substantial real depreciation of the exchange rate, which will strengthen the export lobby. It is also probably wise to avoid further increases in the opposition, which might follow the announcement of explicit liberalization of the import control regime itself. With this consideration the central question of explicit liberalization of imports arises.

Arguments For and Against Simultaneous Import Liberalization

There appear to be few cases, indeed, where a program of import liberalization — by which is meant here a deliberate reduction in the level and variance of protection against imports and a move to reliance on the price mechanism rather than controls — has coincided with the introduction of a stabilization package of the kind discussed above. Chile may be an exception, and a close examination of that experience does not, in fact, tell one much about its wisdom (since it was not the import liberalization that created the problem for Chile, but rather allowing the real rate of exchange to appreciate between 1979 and 1981). Nevertheless, while the situation always varies from country to country, there do seem to be good arguments against carrying out a radical program of trade liberalization at the same time as stabilization.

The first and perhaps most important consideration is the problem of the *conjuncture.* It is an almost inevitable concomitant of the stabilization program that there will be recession and economic disruption on a large scale. There is a real danger that liberalization of imports will be permanently tarred with this brush if it is carried out at the same time. It is far better to let protection be blamed for the recession.

The second consideration is also political. It is already clear that there will be substantial opposition to the program of stabilization. Much of that opposition is likely to be diffused, however, because the groups affected are very large and, for that reason, they are usually poorly organized. This does not, however, apply to producers of specific import-competing products. They will suffer in any case, though they will often be unaware of this, as a result of the reduction of the anti-export bias. It is when something visible affects a concentrated group that one has to watch out. If an explicit reduction in the tariff is added to the package, a hornet's nest of well-organized producer interests is likely to buzz around the government's ears, making the whole program even more difficult to execute.

Thirdly, and on a more strictly economic note, the existing pattern of protection will be unknown before the implicit quota premia are mopped up by the exchange rate adjustment combined with improved availability of foreign exchange. This being the case, it is generally impossible to judge the significance of any announced reduction in tariffs for the affected producers. There simply is not the required information.

Fourthly, there is some evidence that the costs of economic dislocation are themselves related to the speed and extent of changes in relative prices and market conditions. A major liberalization, added to all the other required policy changes, could create significant adjustment costs, especially when the overall macroeconomic conditions are likely to include a recession, with low rates of investment a salient characteristic. Adjustment is inevitably more difficult in these circumstances.

Finally, there is some evidence that the anti-export bias is itself the worst feature of import control regimes, and this suggests that the reduction of this bias is the right place to start.

Against these points one can only note that theoretical and empirical work suggests that import liberalization seems to create modest adjustment problems by comparison with the stabilization itself. It may also be suggested that liberalization may not occur once the crisis is over. The latter argument could well be valid, though there are several cases of countries that have built on stabilization to liberalize imports, Greece, Israel and Spain all being important examples. There may be an argument for *announcing* the intention to liberalize, along with plans on how it is to be done, at the same time as the stabilization, while not actually liberalizing. Even this could be counterproductive, however, since lobbying against future reductions in protection could start immediately, without the benefit of support from those who will turn out to be benefited by those changes and are not yet aware of it. *It must always be remembered that the existing productive structure is always politically overrepresented.* Politics is usually economically conservative. It may be concluded that it is not obvious whether the intention to liberalize should be announced at the same time as stabilization-cum-devaluation.

Nevertheless, it would be desirable to move to tariffs as quickly as possible, in order to facilitate the subsequent liberalization program by increasing knowledge about the protective structure. Furthermore, there is a serious danger that the liberalization of import controls following successful stabilization-cum-devaluation will be concentrated on capital goods and intermediates, so leading to *increased* variance in the incentives for resource allocation (as happened in the case of India in the late 1970s). For these reasons, it may even be sensible to *raise* low tariffs towards the higher levels during the initial stages, the aim being to increase the uniformity of protection and render as many quantitative restrictions as possible redundant. Auctioning of quotas could be a step towards this end. At the same time, liberalization of quantitative restrictions should be as across-the-board as possible, in order to avoid increasing relative protection to the production of so-called "inessential" goods.

How Stabilization Fails

Again and again one finds that these stabilization efforts represent mere spasms in a long history of protection and macroeconomic instability. It is only in a limited number of cases that stabilization works permanently, so providing the platform on which a particular liberalization episode can be turned into a long-term process of liberalization. What is the reason for the spasmodic nature of policymaking in so many developing countries? The answer appears quite simple. The balance of payments situation again gets out of hand, the reason being that either the underlying public finance problem is unsolved or the exchange rate adjustment is inadequate. In the first case, the new policy will prove economically unsustainable, with inflation and the current account deficit rising yet again as a result of continued monetary expansion. In the second case, it will prove politically unsustainable, in addition, because of the depth of the associated recession. Such an episode can be regarded as no more than a rationalization of policy in the short term. Unfortunately, the failure will further lower the credibility of government for the future, so making eventual success ever more difficult to achieve.

Liberalization of the Structure of Protection

With the above discussion the issue of trade liberalization has already arisen. This topic is the focus of the present section and the discussion proceeds on the assumption that the country concerned starts in internal and external balance, that is, with full employment and a sustainable balance of payments position.

It is evident from both theory and experience that a liberalization process proceeds most smoothly if it is credible, predictable and transparent, while not absolutely instantaneous. Economic agents need at least some time to adjust, if the costs of adjustment are to be contained. Experience in Chile indicates that four years or so may be a lower bound to the process, though there is no overwhelming reason why this should be so. Conditions unique to a country, such as its geographical size, pattern of comparative advantage and entrepreneurial base, will all influence the process. In practice, most processes of economic liberalization, of which trade policy is just a part, have taken as much as a generation or so, as the economy has evolved and both economic agents and the government have gained confidence in the acceptability and workability of the idea of economic liberalism. Here, too, there is learning-by-doing.

Theory also suggests that it would be best if the process were "Pareto efficient" along the way or, in other words, if economic efficiency were to improve at each successive stage. It is known that high protection creates proportionately more costs than low protection, and that a large variance in protection is more costly than a more even pattern of protection. It is also desirable, as has been suggested above, to avoid explicit export subsidies, since these tend to miss many important potential exports as well as attract countervailing duties. For this last reason, it is desirable to lower the average level of protection reasonably rapidly, since the bias against exports would otherwise remain very large.

The most desirable way of proceeding is probably, first, in the stabilization phase, to remove quantitative restrictions and achieve some uniformity in the tariff structure by raising very low tariffs; and, second, shortly thereafter, to start lowering tariffs progressively via the "concertina" method, which implies reducing high tariffs first, while leaving the lower ones until the end.

Unilateral and Multilateral Trade Liberalization

The question is whether this orderly, objective, pre-announced and efficient path is politically feasible. It is this issue that arises when one considers the alternatives of unilateral and multilateral liberalization, a distinction of great importance in the postwar world.

Unilateral Liberalization. Most countries liberalize unilaterally. In this situation, a government has both a major advantage and a major problem. The advantage is that, in theory, the government can liberalize in the most efficient possible way. Since a small country can, in any case, have little influence on the trade policies of the rest of the world, such unilateral liberalization, if possible in the first place, is probably the most desirable way to proceed. The problem is that it is difficult in the extreme to make a pre-announced unilateral liberalization credible.

The reason for the difficulty is that all those adversely affected have a good reason to lobby against the announced change. Furthermore, opposition groups and parties enjoy the opportunity to gain political support by backing those who are lobbying against the change. The government will face considerable pressure to reverse the policy and, even if the government does not give in, the sight of that pressure will itself render the liberalization process less credible and predictable and so more costly. In short, since a government can hardly ever bind itself unilaterally, many of the advantages of pre-announcement are lost in this case. At the same time, there is the disadvantage that all the opposition will be fully mobilized.

It is probably for this reason that many processes of successful unilateral liberalization seem to have been characterized by a succession of surprises, at least with respect to timing if not to the basic commitment to liberalize itself (on which secrecy is, in any case, probably impossible). In a relatively favorable moment, a government announces a liberalization and then holds on until it has become obvious to all that the required adjustments are modest. Then it liberalizes again. Alternatively, it announces a general intention to liberalize, but puts its intentions into effect at auspicious times and postpones further liberalization whenever macroeconomic or balance of payments difficulties arise. Since the pre-announcement is often pointless, at least in the early stages when credibility is low, such opportunistic, or "higgledy-piggledy" liberalization may well be the best way to proceed for the country liberalizing unilaterally. (An interesting case of planned unilateral liberalization appears to be the Republic of Korea at the moment. One may hypothesize that the Government of the Republic of Korea has exceptional credibility.)

A question arises whether the involvement of the International Monetary Fund (IMF) or World Bank changes the calculation. The answer is that it probably does not to a very large extent. The reason is that there is both widespread and understandable doubt about the credibility of any commitment to future actions by a government in the context of an agreement with these organizations. The main reason for the doubt is that it is unlikely that the international organizations will impose sanctions. Both the IMF and the World Bank find it difficult to pronounce an experiment with which they have been closely associated a failure, since they themselves are implicated. Here, too, it is probably wisest to focus on one, perhaps limited, immediate action rather than commit the country to future actions against which opposition can be readily mobilized on the grounds that the policies are at the behest of these often unpopular international organizations.

Multilateral Liberalization. Even among developing countries, and especially those in the Mediterranean region, multilateral liberalization based on treaties between sovereign states has been of considerable importance. Greece, Israel, Portugal and Spain have all achieved substantial liberalization in such a context, and these countries represent a significant proportion of the successful cases. Multilateral agreements have an advantage and a disadvantage vis-à-vis unilateral liberalization. The main advantage is that multilateral agreements to liberalize over a pre-announced period are far more credible than unilateral announcements. *The only institution that can bind a government is another government.* Treaties can have substantial weight. The main disadvantage is that most plans to liberalize multilaterally involve economic inefficiency, either because they demand discrimination, as in the case of free trade areas and customs unions, or because liberalization depends on a process of reciprocal bargaining that is

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largely devoid of economic logic, as in the General Agreement on Tarrifs and Trade (GATT).

The implications of such an international agreement should be made clear. The essential feature is that trade policy ceases to be a policy variable that can readily be adjusted to the exigencies of other commitments, such as those to excessive public expenditures. On the contrary, trade policy becomes a treaty-bound parameter, to which macroeconomic policy must adjust. Socialist France and Greece are both important examples from the 1980s of what ensues. While most countries in their situation would probably have sustained the public sector deficits and inflation, while introducing import controls, these two countries did the reverse, largely because of their membership of the European Community. In the case of Portugal and Spain, too, membership of the Community, entered into largely for political reasons, constrains trade policy and so choices about macroeconomic policy as well.

Usually, there is no real choice between unilateral and multilateral liberalization. All countries cannot join the European Community! Where the choice does arise, it is important to use the multilateral agreement to convince the public that the planned liberalization will occur, while not allowing it to dictate the structure and path of liberalization. The way this is to be done is for policymakers to be absolutely clear in the negotiations, not so much about what the trade policies of the trading partners should be, over which a developing country will have little influence, as about the desirable path of liberalization for their own country. *It should then be possible to obtain multilateral sanction for a policy determined on essentially unilateral grounds.* Indeed, that has always been the sensible approach to multilateral negotiations.

Associated Policies

It is politically difficult (and some would even argue undesirable) to maintain trade liberalization in the face of large fluctuations in the real rate of exchange. It is open to question, however, whether there can be stability of the real rate of exchange, even with macroeconomic stability at home, if there is freedom from exchange controls, especially under floating exchange rates. Apart from anything else, instability in macroeconomic policy elsewhere, especially in major countries, is bound to spill over onto any country whose economy is integrated closely into world markets for goods and capital. Consider, for example, the fluctuations in the real rate of exchange of the Swiss franc, despite the exceptional stability of Swiss macroeconomic policy.

At the same time, freedom from exchange controls is itself desirable, not least if efficient financial markets are to develop and opportunities for borrowing and lending in world markets are to be exploited. At this point, however, the discussion goes into the closely related but very difficult one of optimal exchange rate and monetary policy regimes for developing countries, a subject beyond the scope of the present article.

Enduring Temptations

It should be remembered that trade liberalization is usually aborted by a crisis in the balance of payments, while such a crisis tends to reflect a problem in public finance. Temptations to play fast and loose with macroeconomic policy will, however, continue to arise. Unfortunately, even societies that have learned the lesson often grow accustomed to success, come to take economic stability for granted and forget its preconditions. To bid for political support with unfinanceable promises can then again become a promising political strategy. Indeed, the very achievement of stabilization will make those temptations still greater, since, with credibility re-established, governments are likely to enjoy a honeymoon period, perhaps of several years, before the next crisis. They can even hope that their successors will get the blame. Societies do, indeed, learn from their history but, unfortunately, they can also forget what they have learned.

Principal Lessons

The main points to bear in mind are the following:

First: It is usually advisable to separate the stabilization and anti-export bias removing phase of a stabilization program from the trade liberalization itself. The reason is that it will be politically easier to start a formal process of liberalization after the stabilization crisis is over, since the potential opposition to the initial program will thereby be reduced.

Second: The key ingredient of the stabilization phase is a reduction in the budget deficit to levels that can be financed in a non-inflationary way, combined with a large depreciation of the exchange rate. Trade liberalization can neither be achieved nor sustained if the public budget cannot be financed in the long term without rising inflation.

Third: It is certainly dangerous and probably always undesirable to use the exchange rate as the principal tool of counter-inflationary policy. The main risk is that the consequent appreciation of the real rate of exchange will damage all industries producing tradable goods and services, making the long-term adjustment to a more open economy far more difficult, both economically and politically.

Fourth: If fiscal and monetary policies are not compatible with the announced trajectory of the exchange rate, use of the exchange rate for counter-inflationary policy is not merely damaging, but futile.

Fifth: Substantial capital inflows can undermine the stabilization program, because of the risk of a large appreciation of the real exchange rate, and should be avoided. In the context of policies leading to such an appreciation, freedom of capital outflow can lead to a massive capital flight. Otherwise, freedom for capital outflows may actually be helpful, making it easier to sustain a depreciated real rate of exchange with less inflationary pressure.

Sixth: It is an important part of the stabilization program that the incentive to export be substantially increased. Decisions to remove formal export incentives should be judged in that light against the planned adjustment in the exchange rate.

Seventh: Liberalization should improve efficiency along the way. The best liberalization process probably involves a move from quotas to tariffs, followed by a pre-announced and credible "concertina" reduction of tariffs over a period of time. The first stage is greatly helped by the initial depreciation, which soaks up a part of the quota premia in the licensing system.

Eighth: A unilaterally announced liberalization may not be credible. For this reason and to minimize opposition it may be necessary for the government to act, at least at the initial stages, by means of a series of surprises, the timing being related to overall economic conditions. It may be advisable, however, to announce a general intention to liberalize, if not the precise timetable.

Ninth: Agreements with international organizations can help the liberalization process, but that help may best be related to immediate actions rather than long-term programs. The credibility of actions announced for the far future may not be raised by the participation of international organizations, which find it difficult to admit that programs with which they have long been associated are not working.

Tenth: Agreements with other governments that bind certain policy instruments altogether can help to lower the costs of liberalization by making it more credible. It is important, however, to avoid getting trapped in too narrow an interpretation of the idea of reciprocal liberalization. Negotiators should try to use the negotiations with other countries to provide a multilateral sanction for what has already been judged to be desirable unilaterally.

Eleventh: Liberalization cannot be maintained if, as is all too easy, macroeconomic and exchange rate policy repeats the mistakes that created the stabilization crisis in the first place.

The final point is quite simple. Stabilization and trade liberalization have worked for many countries in the past. Carefully considered they will work for other countries in the future. It is possible to get from here to there, even if one would have done far better to avoid getting lost in the first place.

Trade Liberalization and Economic Growth in Europe and the United States

Herbert Giersch*

Four decades ago, Hayek and Schumpeter — two giants among the social philosophers of this century — foresaw an irreversible shift towards centralization and bureaucracy.[1] Five decades ago, the American Keynesians, notably Alvin Hansen, predicted secular stagnation. They envisaged a saturation of consumer wants, declining population growth, and a dearth of opportunities for autonomous investments that arise from inventions and innovations and from the existence of a geographic frontier. Both predictions turned out to be wrong. A cyclical decline was mistaken for a trend, similar to the Communist Manifesto which, a century before, had misjudged a period of relative stagnation as an indicator of the inevitable breakdown of the market system.

This article is aimed at refuting such extrapolation of trends. In general, it maintains that the world develops in cycles. In particular, this article argues that: (i) the prewar stagnation was overcome by the postwar liberalization of domestic and international markets; and (ii) the world economy could well develop faster in the years to come if governments can be persuaded to once again embark upon a program of liberalizing markets for goods and services, internationally and at home.

Postwar Acceleration and Liberalization

With regard to economic growth, it may be noted that the prolonged stagnation after the Great Depression was followed by an upturn: a worldwide acceleration of growth in the 1950s and 1960s. As regards controls, it may be observed that prewar and wartime controls in Germany and in countries occupied by Germany during World War II had given people a taste — perhaps an excessively strong taste — of what government involvement and central planning mean, so that Hayek's message in his *Road to Serfdom* was frequently welcomed as a call for a turnaround.[2] People do learn from experience, sometimes even

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[1] Friedrich A. Hayek, *The Road to Serfdom* (London: Routledge, 1944); Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 2nd ed. (London: Allen & Unwin, 1943); Joseph A. Schumpeter, "The March into Socialism", *American Economic Review*, Papers and Proceedings, vol. 40 (1950), pp. 446-456.

[2] In his Presidential Address to the American Economic Association, "The March into Socialism", Schumpeter said, "All that we mean by the 'march into socialism' is the migration of people's economic affairs from the private into the public sphere". Schumpeter, *op. cit.*, p. 446.

intellectuals. The German economic miracle was instrumental for the gradual revival of a belief in open economic systems, be they timidly called "market economies" (free or "social") or more bluntly "capitalism".

In explaining the acceleration of growth in the 1950s and 1960s in Europe, mention must be made of some contributing factors such as postwar reconstruction and wage moderation in Germany, low energy prices, the formation of a common market for manufactures in Europe, and leadership of the United States in worldwide trade liberalization. This liberalization encompassed the removal of quantitative restrictions that had been introduced for balance of payments reasons and a lowering of tariff rates in the framework of the General Agreement on Tariffs and Trade (GATT). In the Kennedy Round (1964-1967) which followed the Dillon Round (1960-1961), tariffs were lowered by 50 per cent across-the-board (with the exception of steel, textiles, clothing and footwear). The average tariff on manufactured products from developing countries decreased by 31 per cent in the United States and by 36 per cent in the European Community. All countries benefited, even the United States. Until 1966, postwar economic growth in the United States and the industrial countries in Western Europe was faster than at any time for which figures are available.[3]

From Acceleration to Deceleration

Tendencies leading to a turnaround (upper turning point of the cycle) accumulated over the second half of the 1960s, particularly in Europe. These included slower growth due to manpower constraints, notably in Germany; more reliance on demand management with promises of full employment; the emergence of a dollar overhang; the Chinese cultural revolution paralleled by the student revolt; a wage explosion in Europe coinciding with an upward revaluation of currencies; a worldwide price hike for raw materials and energy in 1973/74 accommodated by monetary policy; excessive capital deepening in Europe under the influence of distorted factor price relations (depressed real interest rates, excessive wages and energy prices); and a winding down of inflation in Europe without sufficient wage moderation and differentiation, leading to excessive increases in apparent labor productivity and high (non-Keynesian) unemployment. Europe's classical overemployment of the 1960s thus turned into Europe's classical unemployment of the 1980s. In this perspective, the various shocks (wages, energy, environmental) are seen to be endogenous supply-side responses to the unsustainable rates of real economic growth of the 1960s. And present high real interest rates appear as a reaction to the low real rates of the 1970s, reflecting the scarcity of capital relative to the worldwide abundance of labor at given real wages.

In the 1980-1985 period, real gross domestic product (GDP) in the industrial countries grew by only 2.3 per cent per annum, down from rates of 2.9 per cent in 1973-1980, 4.8 per cent in 1963-1973, and 4.1 per cent in 1950-1963. Present growth rates in industrial countries do not exceed the low rates in the second quarter of this century and are lower than the 3 per cent growth rates that prevailed earlier.[4]

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[3] John W. Kendrick, "Why Productivity Growth Rates Change and Differ", in Herbert Giersch, ed., *Towards an Explanation of Economic Growth* (Tübingen, 1981).

Deceleration and Protectionism

While the 4.5 per cent growth of industrial economies in the 1950s and 1960s was accompanied by the opening of markets, the 2-3 per cent growth of the 1970s and the 1980s was paralleled by rising protectionism, both within and among countries. More accurately, when in the earlier period real wages lagged behind the (natural) growth of (distributable) labor productivity, the increasing demand pull on the labor market helped to create a positive sum game mentality in favor of openness: open product markets, an open labor market allowing the south-north migration of manpower in Europe, the removal of controls on the outflow of capital, and openness towards labor-saving technical progress. In the same vein, slow growth later on, resulting from an overshooting of real wages in the early 1970s, not only induced protectionism of the Stolper-Samuelson type against international competition[5] but also a protectionist aversion against technical progress because of its (wage induced) anti-labor bias.

Instruments of the New Protectionism are non-tariff barriers, such as the Multi-Fiber Arrangement (MFA), bilateral import quotas, import licensing, "orderly market arrangements" (OMAs), "voluntary export-restraint" agreements (VERs), safeguard measures, the restrictive application of standards, anti-dumping laws, and the granting of subsidies to domestic producers. The products mainly covered are exports from countries which have embarked upon an outward-looking catching-up process. The purpose is to prevent or to delay the displacement of domestic labor, primarily in old industrial regions with high unemployment and gloomy growth prospects: the textile regions and the "rust belts". It is true that capitalists as well as workers in industries that are subject to increased competition tend to adopt a defensive attitude. But what counts in the political arena are votes from people. Therefore, governments in Western democracies usually grant the highest rates of effective protection to their major labor-intensive industries.

Protectionism feeds on itself. By permitting more sluggishness (x-inefficiency), it is likely to impair the growth of productivity and output. Less growth, in turn, reduces the dynamic margin where structural change can take place without much pain, and more pain from structural change raises the demand for protection in the political arena. This vicious circle has been at work in Europe since the early 1970s. It was certainly aggravated by: (i) the decline of the dollar; and (ii) the emergence of large new capacities for the supply of standardized products, mainly from those Newly Industrializing Countries (NICs) that switched from import substitution to export-oriented policies. But one has to consider, in addition, that in the 1970s Europe was on the march into the welfare state. The impairment of incentives by welfare provisions did not matter much when the economy was moving at full speed in what has been called quantitative growth, but it did matter more when growth slowed down and the requirements of structural change became more important, absolutely or at least relative to growth.

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[4] Irving Kravis and Robert Lipsey, "The Diffusion of Economic Growth in the World Economy", in John Kendrick, ed., *International Comparisons of Productivity and Causes of the Slowdown* (Cambridge, Mass.: Ballinger, 1984), pp. 109-138, Tables 3-9 and 3-15; and International Monetary Fund, *World Economic Outlook* (Washington, D.C., October 1985).

[5] Wolfgang T. Stolper and Paul A. Samuelson, "Protection and Real Wages", *The Review of Economic Studies*, vol. IX, no. 1 (November 1941), pp. 58-73.

These irritations of the 1970s were more apparent in Europe than in the United States or Japan. The economy of the United States, in contrast to Europe, obtained relief from the decline of the dollar, though only temporarily. And Japan, unlike Europe, did not have to cope with a wage shock and rigidity of real wages. On the contrary, real wages were flexible enough to adjust to higher energy prices without a decline in employment. But there are also more fundamental differences between Europe, on the one hand, and the United States and Japan, on the other. Compared with Japan, Europe is less capable of surmounting difficulties by consensus. And compared with the United States, Europe has less market flexibility and more corporatist inclinations such as cartels, barriers to entry, regulations, government ownership, subsidies, nationwide collective bargaining with minimum wage implications, job protection, and co-determination.[6]

It is true that industry in Europe did show a surprising capacity to adjust when the common market for manufactured products was formed after 1957. But two aspects must be considered. First, the adjustment at that time was to competitive pressures from countries at a similar stage of economic development. It called for intra-industry adjustment, often merely for a change in a firm's product-mix, hardly for a closing down of plants, and even less for any layoff of workers. This is in contrast to the new competition from the NICs which involves inter-industry specialization. Second, the adjustment on the labor market required at that time was facilitated by the excess demand for labor, by the classical overemployment, and by the low level of real wages that prevailed before the wage explosion of the early 1970s. This imbalance shifted the adjustment burden onto employers. They searched for guest-workers who were prepared to fill the jobs in whatever place they happened to be and to do the kind of work that had become unattractive to the domestic labor force. Could it be done again?

Domestic and International Liberalization for Faster Growth

After half a generation of relative stagnation, Europe should have prepared the ground for a reacceleration of growth to start in the last quarter of the 1980s. Inflation rates are low; government budget deficits as a share of gross national product (GNP) have been reduced; the wage gap is less than it used to be; employment has started to rise; and the cyclical upswing initially imported from the United States four years ago tends to become self-sustained.

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[6] Herbert Giersch, *Eurosclerosis*, Kiel Discussion Papers, no. 112 (Kiel, 1985).

However, there are still limits to faster economic growth. Schumpeter referred to "(1) the various stabilization policies ...; (2) the desirability of greater equality of incomes ... and ... the principle of redistributive taxation; (3) a rich assortment of regulative measures ...; (4) public control ... over the labor and money market; (5) indefinite extension of the sphere of wants that are ... to be satisfied by public enterprises ...; and (6) ... all types of security legislation".[7] As a first reaction against the emergence of these limits to fast sustainable growth, Europe had its recent rhetoric of monetarism, tax reform, deregulation, denationalization, and self-responsibility. More fundamentally, the political pendulum has swung towards more liberalism (in the European sense) with a change to liberal-conservative governments in Belgium, Denmark, France, Federal Republic of Germany, Netherlands and Portugal, and with socialist-led governments in Austria, Greece, Italy and Spain adopting more liberal or conservative policies. The Commission of the European Community, though under a socialist President, is pushing towards decontrol of the capital market, breakdown of the airline cartel, reform of the agricultural policy, and completion of the internal common market by 1992.

Nevertheless, even if quick action were taken along these lines, Europe would be more than five years behind the United States. For more employment and growth, Europe needs a removal or lowering of barriers – corporatist, bureaucratic and fiscal – to entry in the labor, capital and product markets; for the young and for women; and for the unemployed as well as for potential entrepreneurs. What is required is more openness of markets.

Openness includes import liberalization. It can be demonstrated to have favorable effects on economic growth. The strongest evidence comes from a comparative study covering 32 developing and five industrial countries (where the European Community is considered as one country) by Heitger.[8] He shows that the mean effective rate of protection of this sample accounts for a retardation of economic growth by 1.9 percentage points (on average per annum in the 1960s and 1970s). This finding is based on a production function-type analysis employing – as variables explaining economic growth – (i) the adult literacy rate (as a proxy for human capital), (ii) the share of investment in gross domestic product, (iii) the rate of population growth (as a proxy for labor), (iv) per capita income relative to that of the United States (as a proxy for the technological adaptation potential), and (v) the effective rate of protection. As technology transfer goes along with trade and as it is more important for developing than for industrial countries, one may conclude that openness is even more beneficial for the former than for the latter. Previous studies by various authors confirm the favorable effects of import liberalization on economic growth.[9]

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[7] Schumpeter, *op. cit.*, p. 449.

[8] Bernhard Heitger, *Import Protection and Export Performance — Their Impact on Economic Growth*, Kiel Working Paper, no. 260 (Kiel, July 1986).

It is true that fast growth in the immediate postwar period in Europe greatly facilitated liberalization; but more important for the future is the fundamental point that import liberalization has not only favorable static allocation effects but also favorable effects on economic growth. How do they come about? The answer can be inferred from studies which show that the international sector usually has a higher productivity growth rate than the domestic sector.[10] This has been suspected for a long time. But the explanation was generally thought to be that the international sector meant industry rather than services and that industry had inherent economies of scale. In contrast to this view, I suggest that the difference is competition: strong competition in the international sector; little or no competition in the sheltered domestic sector. This is plausible. Most people would agree that competition makes us work harder and faster and compels us to be more innovative. It was John Hicks who said that the best monopoly profit is a quiet life.[11] Nobody can be expected to voluntarily give up such a monopoly position for the common good; the name of the game is not altruism. But most monopoly positions — outside the government sector — would be gradually eroded if governments refrained from granting import protection. With import liberalization, the sheltered sector will shrink or speed up its development.

Import liberalization is often thought to require reciprocity and, hence, international cooperation. The valid reason is political, not economic. Unless other countries reduce import barriers as well there will be no league of export firms to anticipate direct positive effects on output and employment and to calm down the fears and neutralize the political influence of firms supplying import substitutes. Unilateral liberalization would be politically feasible only if consumers (and importers) had a strong voice in the political arena or if countries were governed by farsighted statesmen who could afford to act in the general interest. Opinion leaders might come to the help of potential statesmen. But a broad movement requires that the general public gets a feeling for the overall gains to be expected from a program of liberalization for faster growth. This feeling will evolve only gradually after a successful start.

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[9] For the favorable effects of import liberalization on economic growth and the positive effects of export expansion on income growth, see Michael Michaely, "Exports and Growth — An Empirical Investigation", *Journal of Development Economics*, vol. 4 (1977), pp. 49-53; Bela Balassa, "Exports and Economic Growth: Further Evidence", *Journal of Development Economics*, vol. 5 (1978), pp. 181-189; Constantine Michalopoulos and Keith Jay, *Growth of Exports and Income in the Developing World: A Neoclassical View*, Discussion Paper, no. 28 (Washington, D.C.: Agency for International Development, 1973); Anne Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences* (Cambridge, Mass.: Ballinger, 1978); Anne Krueger, *Trade and Employment in Developing Countries, 3: Synthesis and Conclusions* (Chicago: University of Chicago Press, 1983); Juergen B. Donges and Lotte Muller-Ohlsen, *Aussenwirtschaftstrategien und Industrialisierung in Entwicklungsländern*, Kieler Studien, no. 157 (Tübingen, 1978); Bela Balassa, *The Policy Experience of Twelve Less Developed Countries, 1973-1978*, Staff Working Paper, no. 449 (Washington, D.C.: World Bank, 1981); Sarath Rajapatirana and Deepak Lal, *Trade Regimes and Economic Growth in Developing Countries*, Paper presented to the Kiel Conference on Free Trade in the World Economy: Towards an Opening of Markets, 24-26 June 1986 (forthcoming). For surveys of the literature on the correlation between export expansion and income growth, see Bela Balassa, "Disequilibrium Analysis in Developing Economies — An Overview", *World Development*, vol. 10, no. 12 (1982), pp. 1027-1038; Bela Balassa and Constantine Michalopoulos, *Liberalizing World Trade*, Development Policy Issues Series, Discussion Paper (Washington , D.C.: World Bank, October 1985); and Ulrich Hiemenz and Rolf J. Langhammer, *Efficiency Preconditions for Successful Integration of Developing Countries into the World Economy*, International Labour Organisation, World Employment Programme Research Working Paper (forthcoming).

[10] Bernhard Heitger, *Strukturwandel und realer Wechselkurs-Ein Zwei-Sektoren-Modell im Test*, Kieler Studien, no. 183 (Tübingen, 1983).

[11] John R. Hicks, "Annual Survey of Economic Theory: The Theory of Monopoly", *Econometrica*, vol. 3, no. 1 (1935), pp. 1-20.

Liberalization, domestic and international, could be facilitated if politicians realized that it is the only means of prolonging a cyclical upswing without rekindling fears of inflation. Indeed, an upswing may be transformed into a process of faster medium-run growth if timely steps are taken to widen supply bottlenecks by removing restrictions and barriers to entry. Haberler once distinguished between incomes policy I and II, i.e., a suppression of price and wage rises by controls or moral suasion, on the one hand, and measures to raise supply responsiveness, on the other.[12] I would not exclude moral suasion and other forms of such incomes policy if they could be designed solely to pave the way towards more openness and long-term growth.

In addition, tax rate reductions to improve the incentive system may have to be included in any program for faster growth; at least in Europe they should be combined with parallel subsidy reductions.[13] Where more employment is likely to reveal a shortage of physical capital (at given real wages and at given time constraints on the use of the capital stock) as I envisage for industrial Europe, the emphasis of the tax cut will have to be on raising the profitability (marginal efficiency) of investment unless profit expectations are boosted by wage moderation. An investment emphasis would tend to raise the exchange rate (upward revaluation) and thus help to convert present export surpluses into domestic investment. In my opinion, liberalization is an indispensable condition for faster growth.

No Reacceleration of Demand without Liberalization

Pressure has been brought to bear on the Federal Republic of Germany to reflate or inflate its economy — without regard to the supply side — for the benefit of its trading partners all over the world. This request diverts from the liberalization issue and must, therefore, be critically examined in this context; it seems to be based on two main assumptions.

First, there is a worldwide Keynesian situation so that a monetary-fiscal stimulus can be considered an international public good. Second, this public good has to be supplied by a country that is able to afford it, thanks to its current account surplus which may be due to a deliberate "beggar-thy-neighbor" policy; or that has an enviably low inflation rate; or that suffers from a gap between actual and potential output; or that is ignorant about how quickly — without additional measures — it could transform a demand stimulus into faster growth of potential output. None of these assumptions can be taken for granted, but I shall focus on the central proposition that an addition to world demand is a public good.

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[12] Gottfried Haberler, *Incomes Policies and Inflation* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1971).

[13] A study based on a simulation model shows that an overall reduction of subsidies by 50 per cent over a period of five years combined with corresponding tax cuts could increase the number of jobs in the Federal Republic of Germany by one million. Egbert Gerken et al, *Mehr Arbeitsplätze durch Subventionsabbau*, Kiel Discussion Papers, no. 113/114 (Kiel, 1985).

Apparently, the world economy is not in an extreme Keynesian situation, i.e., in a recession with a liquidity trap and nominal interest rates so low that they have become stuck for institutional reasons. On the contrary, the world economy is in a rather long upswing, supported by ample monetary expansion, with M_1 (currency and demand deposits) increasing faster than pre-announced (currently at a 10 per cent rate in industrial countries) and nominal interest rates on a declining trend. While the Federal Republic of Germany's actual inflation rate is very low, it is significantly depressed — by the once-for-all fall in the oil price — below the underlying rate; the latter will probably reappear in 1987.

Undoubtedly, demand can all too easily be considered as a public good. All suppliers would like to face more demand to improve their terms of trade without efforts of their own. This is why mercantilism played such a prominent role in history and why promises and policies for full employment tend to be so popular at the time they are initiated. Export-led growth falls into the same category: it was beneficial for Europe in the postwar period until the danger of imported inflation became imminent, and it is advantageous to any developing country — up to a point — to promote export growth by having an exchange rate that is undervalued in terms of producer costs of export goods that have a high income elasticity of demand. But there is a price to be paid: the terms of trade are worse than they could be.

The view of demand as an international public good is a cheap excuse. Even a Keynesian situation could be avoided or overcome by every country acting on its own and in its own interest (provided it has not surrendered its autonomy by tying the exchange rate to a hegemonic currency). And if, in the present situation, a country such as the Federal Republic of Germany should be judged to offer opportunities for more expansion and faster growth, the advice to expand could well be based on the country's interest, rather than on an altruistic notion of contributing to a supposedly public good to be supplied with a fair burden sharing.[14] But an acceleration of growth in the Federal Republic of Germany, or any other country, is not without costs to the rest of the world. It is, therefore, a matter of give-and-take, and consideration should be given on how to lower these costs. Inherently, there are no non-pecuniary spillover effects that would make it an international public good.

In my opinion, the Federal Republic of Germany would be well advised in its own interest to pursue a policy designed to transform its present export surplus into domestic investment. The main reason is that the present unemployment is of a capital shortage type. With given labor market rigidities, the available capital stock is the major constraint; it is insufficient for a productive employment of most of the unemployed. Hence, there must be high social returns from domestic investment. However, to transform the export surplus into domestic investment is likely to involve much time. It will require a policy of making this investment more profitable for business, more profitable relative to portfolio and direct investment abroad. For this purpose, many participants in the policy debate have urged the government to implement the 1988 tax cut together with the reduction made earlier this year. And most of us have submitted parallel proposals to raise the profitability of investment by making the labor market more flexible and by dismantling restrictive government monopolies and regulations.

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[14] The argument that the Federal Republic of Germany should reflate to the benefit of its trading partners can be considered in two versions. According to the first version, the world economy suffers from a deficiency of overall demand. Filling the gap is a duty that some country has to perform, preferably a country which could most easily do it (in the judgment of others). In the second version, world demand is not deficient; but there should be an international redistribution of the monetary and fiscal policy-mix, a better sharing of the burden among countries. According to this view, the Federal Republic of Germany (and Japan) — having benefited from the U.S. fiscal expansion — should now adopt a more expansionary fiscal stance to bring down the dollar and to relieve producers in the United States of pressures from import competition. However, this policy advice rests on the questionable assumption of world demand being a public good to be supplied in common. It neglects policy constraints and preferences in the Federal Republic of Germany, where deficit spending has been much more suspicious of leading to inflation than a monetary acceleration under the auspices of the Bundesbank and where an unsustainable demand expansion is feared to have price effects rather than output effects, given the inflation trauma and the sclerotic conditions of the labor market. This does not rule out a program of faster growth that puts a major emphasis on incentives, market flexibility and openness.

Such a policy would help the United States and the over-indebted less-developed countries to improve their foreign balance. For the less-developed countries, the help would be towards solving the transfer problem of servicing and repaying their foreign debt. This is at present one major positive contribution of the current account deficit of the United States to the world economy. But such help (by the Federal Republic of Germany or Japan or any country) serves its purpose only if the debtor countries reduce their domestic absorption of potential export goods and improve their export-mix. A domestic adjustment of this kind would also be a requirement for the reduction of the current account deficit of the United States. The adjustment needed here is, of course, a reduction of the budget deficit.

This indicates the costs involved. If the Federal Republic of Germany raised the profitability of investment and nothing else happened, then other countries, including the United States, would experience a crowding-out process on the international capital market pushing up real rates of interest everywhere. It is through these higher rates that the countries in need of improving their foreign balance will receive the signal for reducing domestic absorption.

It may be objected that real interest rates are already excessively high and should not be allowed to rise any further. Those who believe this to be true should argue for a smoothing of the adjustment process by close international policy synchronization: investment incentives in the Federal Republic of Germany paralleled by tax increases or expenditure cuts in the United States. Incidentally, the implication of high real rates of interest is that the world economy is not in a Keynesian situation. There are no resources that could be easily put to work, at given relative prices and without adjustment elsewhere.

Concerted Liberalization with Coordinated Expansion

Yet there are vast resources that could be tapped by political entrepreneurship by removing barriers to trade and capital movements. It is in trade liberalization that a concerted effort is politically indispensable: an international cartel of entrepreneurial politicians, or statesmen, against their protectionist domestic pressure groups. For this task, the discussion about macroeconomic coordination now fashionable is a side issue, if not a red herring.

With more open markets and with relative prices better adjusted to relative scarcities (bottlenecks as well as excess capacities), the world economy could tap the productivity potential arising from competition and a more intensive division of labor. With faster growth, better use could be made of the resources which are now behind much of the protectionist pressures: high rates of unemployment together with excess capacities in land transport and maritime transport, in shipbuilding and steel, and in some traditional industries in both developing and advanced countries. In this perspective, world output and its growth rate could, in my view, be definitely higher although we do not know by how much. I venture to argue that it would be worth finding out by experiment. Admittedly, this experiment would require drastic measures on the supply side, including tax reductions favoring investment, but they are worthwhile. I am confident that much of the new investment would be directed towards widening the bottlenecks that are likely to arise in the process of reacceleration. If real rates of interest should remain rather high — and even more so if they should rise in combination with wage moderation — this investment could have a surprisingly high capacity effect on the grounds that: (i) it may go more into modern services than into manufacturing; (ii) its capital intensity (capital/labor ratio) may be low under the influence of capital-saving innovations; and (iii) it may be complementary to much of existing capacities that presently appear to be obsolete because of slow growth and high levels of protection.

Such a program of growth with, or through, liberalization would be a forward-looking answer to the structural problems which give rise to the new protectionism in the United States and to the imminent fears that a process of de-industrialization is threatening its economy. As indicated earlier, structural change in the United States was slowed down by the decline of the dollar in the 1970s. Similarly, the pressing structural problems of today are thought to be alleviated by a weakening of the dollar as a substitute for outright protection. This is an inappropriate solution. But a reacceleration of world economic growth along the lines described here would — if only temporarily — make a better use of the traditional industries in the United States, thus reducing protectionist pressures and permitting a higher dollar for the benefit of the exports of less-developed countries.

Structurally weak firms, however, will have to adjust under the pressure of competition, by making product or process innovations, by lowering wages, by shifting their location to low wage areas, or by closing down. Product innovations are offensive and preferable, process innovations are defensive and second best from a cosmopolitan point of view (as they might lead to an excessive capital intensity in the world economy). Closing down, the alternative which appears to be least desirable in the short term, would be definitely better than protection in the medium term since it does not lock in resources in uses without a growth potential.

The political problem is one of bridging the gap between the short and the medium term, between the periods of elasticity pessimism and elasticity optimism, and between demand and supply effects. Although I am far from considering myself a Keynesian, I would dare — in a Schumpeterian spirit — to recommend a monetary-fiscal stimulus as a bridge, on the indispensable condition, however, that the period during which money illusion (or a wage and price lag) can be counted upon to prevail will be effectively used for liberalization — in every country's own interest, adding medium-term pressures of intensified competition to the short-term wage and price lag.

Difficulty of the Task

The task of trade liberalization would appear more manageable if leadership were readily available, leadership based on strong convictions. While Britain in its liberalization effort in the nineteenth century may have been moved by intellectual insights, the United States, as the "hegemon" of the twentieth century, has never been ideologically committed to the principle of free trade. In the history of the United States, the mercantilist view of exports being beneficial and of imports being a necessary cost has always played a prominent role.[15] It was only after 1945 that the United States became an active proponent of free trade, in general, and of unconditional "most-favored-nation" treatment, in particular. With European and Japanese competitors partly in ruin, industry in the United States was believed to be very competitive, having much to gain from free access to overseas markets.[16] With the European Recovery Program, the United States provided an incentive for European liberalization, encouraging the Federal Republic of Germany, the European country with great potential weight but without bargaining power, to adopt a rather liberal foreign trade regime.[17]

In retrospect, the postwar liberalization effort met with surprisingly little resistance in the first two decades when, as noted earlier, structural change posed no severe problems because of high growth rates. The situation is different now. Protectionism has been on the rise again. There is even a trend towards industrial selectivity, as may be observed, for example, from the trade regime of the Federal Republic of Germany (tariff rates, non-tariff barriers and subsidies).[18] Although still relatively liberal in comparison with other European Community countries, the Federal Republic of Germany heavily protects the traditional sectors of mining, iron and steel, shipbuilding, and textiles and clothing. In 1982, they were significantly more protected than in 1972, as were agriculture and the (supposedly infant) aircraft and electronic data processing equipment industries.

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[15] James Riedel, *"Trade Policy in the United States: From Multilateralism to Bilateralism"*, Paper presented to the Kiel Conference on Free Trade in the World Economy: Towards an Opening of Markets, 24-26 June 1986 (forthcoming).

[16] Robert Baldwin, "The Changing Nature of U.S. Trade Policy since World War II", in Robert Baldwin and Anne Krueger, eds., *The Structure and Evolution of Recent U.S. Trade Policy* (Chicago and London: National Bureau of Economic Research, 1984), pp. 5-27.

[17] Gernot Klepper et al, *Protection in Germany: Toward Industrial Selectivity*, Paper presented to the Kiel Conference on Free Trade in the World Economy: Towards an Opening of Markets, 24-26 June 1986 (forthcoming).

[18] Klepper et al, *op. cit.* As a member of the European Community, the Federal Republic of Germany cannot set its own tariff rates, but it can shape the structure of non-tariff protection to a large extent either by granting subsidies on a national basis or by pushing for anti-dumping measures and a country-specific allocation of quotas in Brussels.

Once the principles of tariffs only and of non-discrimination had been eroded after the mid-1960s, the lack of transparency of the political process leading to specific protectionist measures and the rich assortment of non-tariff barriers available made it easy for sectoral interest groups to lobby for favors without alarming the general public. This holds for Europe with its subsidies as well as for the United States, where Congress has enacted vague guidelines which put much discretionary power into the hands of mid-level bureaucrats, who, in turn, are frequently approached directly by the various interest groups.[19]

In the public policy debate in the United States, proposals for granting more protection to domestic producers are frequently defended as measures to reduce the current account deficit. However, while the protection of a specific ailing industry might temporarily slow down its decline, the impact of a higher overall level of protection on the current account is likely to be small. More overall protection would raise the exchange rate of the dollar, thus hurting the competitiveness of the United States on the export side and in the field of import substitution. The current account deficit of the United States has deeper roots. It reflects an imbalance between private savings, on the one hand, and investment and public dissaving, on the other. As noted above, the required adjustment would be to cut the budget deficit. More protection would mean more x-inefficiency and less allocative efficiency in the United States and the rest of the world. A bilateral balancing of trade, as has been advocated implicitly and even explicitly, is against the fundamentals of a multilateral trading system; it would deprive the United States and the world of much of the gains from exploiting diversity by trade.

The notion of "fair trade" plays an increasingly important role in public policy debate in the United States. "Fairness", alien to a free market, has become a central issue mainly because governments everywhere frequently intervene in the market process, subsidizing ailing industries and distorting comparative advantages.[20] This might give rise to a vicious circle, with every government justifying its protectionist measures by pointing to previous interventions of other governments. The idea of fair trade would lose much of its appeal if changes in competitive positions were always the result of anonymous market forces and could never be blamed on deliberate actions of a foreign government. This is perhaps the most important reason why the demand for liberalization of trade in goods and services has to be supplemented by a demand for less government intervention at home.

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[19] Riedel, *op. cit.*

[20] Riedel, *op. cit.*

Trade Negotiations and Developing Countries in the Asian and Pacific Region

Kim Kihwan*

Since the subject of the New Round on multilateral trade negotiations was raised at the annual meeting of the "contracting parties" of the General Agreement on Tariffs and Trade (GATT) in 1982, there has been considerable discussion on the New Round in various international forums. The preparatory process has not been very smooth, but at long last, the countdown has started.[1]

Developing countries in the Asian and Pacific region have a great deal at stake in the New Round. For the most part, their economies are highly dependent on the continued expansion of trade. As a result, these countries have suffered the adverse consequences of rising protectionist trends in recent years more than any other group of countries. If the world trading community fails to arrest these trends, they have the most to lose.

In view of this vital interest at stake, this article first outlines the issues that are likely to be included in the agenda and the mode of negotiations most likely to be adopted for the New Round. It then proceeds to assess the benefits and costs of the New Round with special reference to the developing countries of the Asian and Pacific region. Finally, the article concludes with a number of observations regarding the broader interests of these countries in the New Round.

Although the analysis is preliminary, it nevertheless suggests that, on balance, the potential benefits of the New Round exceed the potential costs for the developing countries of the Asian and Pacific region. For this reason alone, these countries should take the lead in the successful launching of the New Round.

Objectives, Agenda and Mode of Negotiations

Objectives. The fundamental aim of the New Round should be to accelerate growth of the world economy by expanding trade. In the various discussions on the New Round over the past four years, at least four objectives have been identified. They are: (i) to arrest and reverse protectionist trends in world trade;

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[1] Since World War II, there have been seven rounds of multilateral trade negotiations under the auspices of GATT. This article was written before the New Round, the eighth, was launched in September 1986 with the establishment of the agenda for trade negotiations in the coming years. Nevertheless, the issues discussed in this article remain relevant to any trade arrangements that may be adopted under the New Round.

(ii) to promote trade liberalization in traditional sectors by resolving old issues that have been left from previous rounds of trade negotiations; (iii) to strengthen the GATT system by undertaking fundamental institutional reforms; and (iv) to establish a framework of rules and disciplines to deal with the new issues in world trade.

The issues likely to be included in the agenda that are intended to arrest and reverse protectionist trends are "standstill" and "rollback".[2] The old issues, the resolution of which will promote trade liberalization in traditional sectors, will probably include: safeguards; trade in agricultural and tropical products and in textiles and clothing; quantitative restrictions and non-tariff barriers; tariffs; and anti-dumping and countervailing duties. The issues likely to be adopted in the agenda which will have the effect of strengthening GATT include dispute settlement procedures, reforming GATT as an organization, and special and differential treatment for developing countries. Finally, the new issues that require a framework of rules are likely to include services, trade-related investment, and intellectual property.

The Agenda. It is almost certain that some kind of standstill on further trade restrictions will be declared when the New Round is launched. When the trade ministers from some 15 countries met in Seoul in May 1986, they unanimously agreed to make standstill a precondition for launching the talks. The need for such a commitment is clear: countries can hardly negotiate reductions in existing trade barriers while new ones are being introduced. More importantly, standstill is needed to give credibility to the New Round, for without it the proponents of the New Round cannot possibly hope to convince the less enthusiastic countries that their commitments to liberalize trade are genuine.

There has yet to be agreement on what kind of measures and sectors should be covered by standstill. In order to succeed, the standstill commitment needs to be as broad as possible. Countries should refrain from taking any further restrictive or distorting trade measures that are inconsistent with or not covered by GATT.

The success of the standstill commitment will also depend upon the extent to which standstill is enforced. Previous standstill commitments, such as those taken at the GATT ministerial meeting of 1982, trade ministers' meetings of the Organisation for Economic Co-operation and Development (OECD), and numerous economic summit meetings, were either ignored or violated soon after they were made because adequate enforcement mechanisms were lacking. For this reason, there is a wide consensus that such mechanisms must be provided. Standstill must be equipped with "teeth". To provide the "teeth", a standstill committee is likely to be established, separate from the Trade Negotiations Committee and the GATT Council but accountable to both bodies. Participating countries as well as the GATT Secretariat could notify the standstill committee of violations of the commitment, whereupon the Committee would fashion suitable responses with a minimum of delay.

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[2] "Standstill" refers to the avoidance of new protectionist measures while negotiations are in progress and "rollback" to the phasing out of existing ones.

Rollback refers to the phasing out of trade restrictions that are inconsistent with GATT provisions. There are views, however, that rollback should also include measures consistent with GATT provisions but not based on GATT principles, such as restrictions on trade in agriculture and the Multi-Fiber Arrangement (MFA). It should be noted that regardless of which definition of rollback is adopted, trade in agriculture and trade in textiles and clothing are likely to be dealt with as individual items because of their special importance in world trade.

For rollback to be credible, it should apply to trade in goods and constitute a commitment to phase-out in accordance with a time-bound schedule. Without this type of rollback, it is unlikely that some key developing countries would agree to participate in the New Round. It is worth noting that most drafts of the Ministerial Declaration submitted to the New Round Preparatory Committee, such as those presented by Japan, by the European Free Trade Association (EFTA), and by Brazil on behalf of a number of developing countries, all emphasize that both standstill and rollback are indispensable elements of the Ministerial Declaration.

The issue of safeguards centers on three interrelated problems. First, a country invoking Article XIX of GATT is required to compensate trading partners that are adversely affected as a result of emergency action or face the possibility of retaliation.[3] This requirement has led many countries to resort to "grey-area" measures outside GATT. The proliferation of such measures has perhaps undermined GATT disciplines to a greater extent than any other single factor.

Second, the desire to minimize compensation to trading partners affected by emergency action has induced some countries, some members of the European Economic Community (EEC) in particular, to argue for a selective application of safeguard action. In their view, such action should be allowed to be taken against one or a few countries that are the major source of market disruption or import surges. This argument, however, has met with opposition from most other countries, which maintain that selective application would be inconsistent with the GATT principle of non-discrimination.

Third, the criteria under which Article XIX may be invoked have never been clarified. For example, the term "serious injury" has not been clearly defined. Moreover, limits have not been placed on the duration of emergency action. In the absence of a limit, troubled industries have no incentive to undertake structural adjustment, a process essential to the expansion of world trade.

In view of these problems, it is not surprising that the great majority of contracting parties are convinced that the issue of safeguards should be given first priority for agreement in the New Round.

It is almost certain that agriculture will be an integral item on the agenda for the New Round. Trade in agriculture accounts for about 15 per cent of world trade, and yet this important sector is by and large outside GATT disciplines. Whatever rules or regulations exist, they themselves constitute exemptions from GATT rules and principles. This is largely the result of the unwillingness on the part of the major developed countries in the past to treat trade in agriculture as they did trade in manufactured goods. In any event, it would certainly make no sense to talk about expanding trade through negotiations while leaving a major sector of trade outside the GATT system. Without agriculture on the agenda, countries which are heavily dependent on trade in agriculture would have little incentive to join the talks. This is particularly true of Argentina, Australia, Canada, New Zealand and the countries of the Association of Southeast Asian Nations (ASEAN) with the exception of Singapore.

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[3] Article XIX provides for emergency protection against imports of a particular product.

It is ironic but important to note that the United States, which historically opposed bringing trade in agriculture under GATT disciplines, has reversed its position on this issue and has given it top priority on its agenda for the New Round. Furthermore, it is worth mentioning that some countries which have been reluctant to include trade in agriculture on the agenda, such as France, Japan and Switzerland, are now realizing that the cost of government support programs and export subsidies to agriculture has reached unmanageable proportions and that multilateral efforts to reduce distortions in this sector of trade will be less painful than going it alone.

Another important sector of trade that needs to be brought under GATT rules and principles and liberalized in the course of the New Round is textiles and clothing. This is probably the single most important area of trade for developing countries, because it is the sector in which they possess strongest comparative advantage. Yet the bulk of world trade in textiles and clothing has been regulated by a succession of restrictive multilateral trade agreements, of which MFA is the current regime. These trade regimes were intended to be temporary, but they have lasted for 25 years. Although sanctioned by GATT, the MFA and its predecessor arrangements have deviated from both the letter and spirit of GATT. Under these arrangements, the interests of the developing countries have been seriously compromised; many of these countries feel that the continuation of restraints on trade in this sector will seriously impede their efforts to industrialize their economies.

In this context, two developments are worth noting. First, in July 1986, the MFA was renewed for another five years with more restrictive provisions. Previously unrestricted, natural fibers such as linen, ramie and jute are now subject to restraint. Furthermore, MFA IV makes it easier for importing countries to take emergency action to prevent sudden import surges into their markets and allows importing countries to impose emergency restrictions for two years instead of one. Second, over the last few months, the United States succeeded in pressuring three major exporters of textiles and clothing, namely, Hong Kong, Republic of Korea[4] and Taiwan to renegotiate their existing MFA bilateral agreements with the United States. Under these new agreements, access to the textiles market of the United States over the next three years has been significantly reduced for these countries. In the case of Korea, textiles exports have been limited to an average annual growth of 0.825 per cent per year from 1986 to 1989. These developments have not helped to make the developing countries more enthusiastic about the New Round. On the other hand, it should be remembered that these outcomes might have been avoided if the developing countries had cooperated more fully for an earlier launching of the New Round.

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[4] In this article, references to "Korea" are to the Republic of Korea.

Past GATT negotiations before the Tokyo Round (1973-1979) focused mainly on tariff reductions. While these negotiations succeeded in reducing tariffs, countries have increasingly resorted to quantitative restrictions and other non-tariff barriers as a means of protecting their industries. Today the most important restrictions on trade are largely non-tariff in nature. Unlike tariffs, these barriers are "non-transparent". Furthermore, they do not allow the most efficient suppliers to meet demand, nor do they permit supply to adjust smoothly and continuously to changes in demand. If this problem is not dealt with successfully, the prospects for expansion of world trade are indeed dim.

It should be noted that there is a distinction between quantitative and non-tariff restrictions which are GATT-consistent and those which are not. For the former, the solution takes the form of further trade liberalization; for the latter, the solution amounts to implementing standstill and rollback. In either case, the harm done to world trade by quantitative restrictions and non-tariff barriers cannot be underestimated. They must, therefore, be part of the agenda for the New Round.

It is often thought that tariffs are no longer major barriers to trade. Admittedly, average tariff rates in developed countries are low, but high tariffs still remain on certain items in which developing countries have comparative advantage such as textiles, clothing and leather products. Furthermore, additional high tariffs are likely to emerge once current quantitative restrictions are converted to tariffs or their equivalent. In addition, tariffs in many developed countries are high on finished goods compared with intermediate inputs. This problem, known as tariff escalation, needs to be addressed because it constitutes a serious obstacle to industrialization efforts, particularly in resource-rich developing countries.

During the Tokyo Round, codes were adopted to deal with abuses relating to anti-dumping and countervailing duty actions. Nevertheless, the problem persists; developed countries still frequently resort to "fair" trade laws to harass competitive suppliers, which more often happen to be from developing countries. This is often demonstrated by national authorities that make different determinations for similar anti-dumping or countervailing duty cases. In addition, there is little consistency in determinations made by different countries involving similar cases. Given these problems, there is a clear need to improve GATT's anti-dumping and subsidies codes with a view to bringing national practices under stricter GATT discipline.

In every preliminary discussion on the launching of the New Round, the settlement of trade disputes has been a key concern. Undoubtedly, the first crucial step towards strengthening the GATT system is to make it an effective arbiter of trade disputes. In this regard, GATT suffers from at least four shortcomings.

First, GATT relies heavily on voluntary bilateral consultations as the primary mode of settling disputes between or among the countries concerned. When GATT makes use of panels to resolve disputes, recommendations are almost invariably made on the basis of consensus of all parties concerned. Even when these processes work, they are time-consuming. Second, expert panels are often manned by persons who lack political independence as well as professional expertise. Third, GATT does not have the power to impose decisions on sovereign nations. In other words, contracting parties can ignore GATT decisions, and they often do. Fourth, there are areas in which GATT obligations on the part of contracting parties are highly ambiguous. When disputes arise in such areas, panels can only suggest ways of clarifying the rules; they cannot make definitive recommendations.

Unlike the World Bank or the International Monetary Fund (IMF), GATT is not a full-fledged international organization. Rather, it remains an agreement setting up rights and obligations of contracting parties relating to international trade. As such, GATT only provides procedures for resolving trade issues through consultations and negotiations. It does not have the power to make policies, enforce commitments, nor to adjudicate disputes between or among contracting parties.

As a consequence, GATT has little authority in trying to resolve problems facing the world trade system on its own initiative. For example, it is not equipped with the mandate to publicize existing trade barriers or to monitor violations of GATT rights and obligations. Unlike the IMF, it cannot even issue country reports regarding trade policies and practices on its own authority.

In most critical matters, GATT decisions are made by consensus. This practice is not necessarily inappropriate when the number of contracting parties is limited. However, there are now more than 90 contracting parties and, as a result, decision-making at GATT is at best time-consuming and at worst fails to produce decisions of any practical consequence. Yet for the GATT system to remain relevant in a rapidly changing world economy, it must be capable of making policy decisions in a timely manner.

Furthermore, the inadequacy of the GATT Secretariat has often been noted. With its limited staff and resources, the Secretariat cannot provide the necessary support for all the functions that ideally GATT should perform. These are to: (i) monitor policies and practices of member governments which either restrict or distort trade; (ii) provide a forum for consultations and negotiations on trade matters; (iii) serve as a mechanism to avoid serious trade problems and conflicts; (iv) provide a procedure for the enforcement of commitments undertaken by member governments; (v) provide technical assistance and advice on trade matters to developing countries; and (vi) undertake research on world trade issues and problems.[5]

An issue which has not been identified explicitly as an item for negotiation but which is likely to be a major issue concerns special and differential treatment for developing countries. This is a subject of a great deal of dissatisfaction for both developed and developing countries. Most developing countries feel they have not been given special treatment to the extent envisaged in Part IV of the GATT.[6] On the other hand, many developed countries perceive Part IV as a major departure from the "most-favored-nation" (MFN) principle which led to an asymmetry of rights and obligations on the part of developing countries. As a solution to this problem, many developed countries have suggested a dynamic interpretation of special and differential treatment. Under this interpretation, developing countries would graduate from such treatment as their economies develop. Some developed countries are of the view that Part IV should be abolished.[7] Because of the important implications of this issue for the integrity of GATT disciplines, as well as its practical consequences for developing countries, all contracting parties should be prepared to squarely face this issue in the forthcoming New Round.

Establishing a framework for conducting and liberalizing trade in services is a priority objective for a number of developed countries. For the United States, developing an internationally agreed system of rules for the regulation of trade in services similar to GATT rules concerning trade in goods is the sine qua non of the New Round. The services sector accounts for 40-50 per cent of gross national product (GNP) in the major industrial countries, and it is of increasing importance in world trade. Currently, trade in services accounts for about 25 per cent of total world trade, and this share is expected to increase.

Another broader reason why the United States feels that trade in services must be dealt with in the forthcoming trade talks is that in today's world, trade in goods is increasingly mingled with trade in services. It is impossible to separate GATT disciplines on trade in goods from those on trade in services and vice versa. The problem is that not every country has perceived this issue in the same light.

Some developing countries, particularly Brazil and India, believe that trade in services, along with investment and intellectual property (patents and copyrights), are issues alien to the jurisdictional competence of GATT. In their view, promoting these new issues would risk the danger of neglecting the central issues which are the traditional responsibility of GATT. Another important reason why these countries believe that trade in services should not be dealt with in the New Round, is that, in their view, many services sectors are in the nature of social infrastructure which plays a critical role in economic development. Extending national treatment to foreign concerns in such sectors could seriously weaken the ability of the government to promote social and economic development. In addition, it is worth noting that discussions on services so far have tended to focus only on those areas where developed countries seem to enjoy comparative advantage, such as banking, insurance, telecommunications, computer software, and legal services. This bias is probably related to the fact that developing countries on the whole have failed to take an active part in the discussions on services at GATT.

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[5] For further discussion on this and other institutional issues concerning GATT, see Lawrence Krause, "The Developing Countries and the GATT", in Young Soogil, ed., *Pacific Perspectives on Trade Policy Issues* (Seoul: Korea Development Institute, 1985).

[6] Under Part IV, developed countries undertake to make efforts to reduce trade barriers affecting developing countries and to refrain from introducing new ones.

[7] Brian Scott, *Has the Cavalry Arrived? A Report on Trade Liberalization and Economic Recovery*, Special Report, no. 6 (London: Trade Policy Research Centre, 1984), pp. 68-91.

The agenda for the New Round is likely to include an item on trade-related investment issues. Although investment issues have not been treated by GATT, government policies on foreign direct investment do affect trade flows. For example, export performance requirements and local content rules applied to investment, as well as incentive schemes for investment, do distort trade. Furthermore, in the world today, direct foreign investment is a powerful force not only for integrating the world's economies but also for stimulating world trade. In view of linkages between trade and investment, it seems reasonable to argue for GATT rules on investment that are similar to those on trade in goods and services. To deal with this problem, the draft of the United States for the GATT Ministerial Declaration proposes national treatment for foreign investors.

There has been growing awareness that laws and regulations on intellectual property can act as effective non-tariff barriers to trade and discourage innovation and the transfer of technology. The issue of intellectual property rights has been raised by the industrially advanced countries. Many firms in Europe and the United States see their intellectual property in those areas pirated by their competitors in many advanced developing countries, including the Republic of Korea and Taiwan. The United States in particular tends to regard such practices as outright theft and, thus, treats the issue of intellectual property as a top priority item in the agenda.

These issues have been raised not only for high-technology areas such as patents for software and biotechnology but also for the protection of traditional patents, copyrights and trademarks. While some developing countries tend to regard international conventions and international organizations such as the World Intellectual Property Organization (WIPO) as the proper vehicles for dealing with intellectual property issues, the United States and many developed countries see GATT as an effective forum for dealing with the trade-related aspects of these issues.

Mode of Negotiations. It is difficult, at this stage, to predict how the forthcoming New Round of multilateral trade negotiations will be conducted. It is, however, certain that the New Round will not be launched unless there is a full commitment to standstill by the major trading nations. Furthermore, there is a good chance that an understanding on rollback may be reached before the launching of the New Round. The high probability that this commitment and understanding will be achieved prior to the launching of the New Round will distinguish the New Round from past rounds.

Every major trading nation that has taken an active part in the preliminary discussions of the past few years has indicated its desire to see the New Round launched with the widest possible participation and to have the negotiations conducted multilaterally. However, it is difficult to rule out the possibility, at this stage, that the New Round will be launched with a limited number of countries. As everyone knows, there has been frequent mention of the so-called "mini-GATT", or the plurilateral approach to negotiations. Such alternatives simply reflect the frustration felt by some major trading nations in attempting to persuade other countries to join the New Round.

Furthermore, because of the urgent need to arrest accelerating trends towards protectionism and bilateralism, these countries have been eager to launch the trade talks at the earliest possible date. Given this situation, there is a real possibility that a number of like-minded countries will launch the negotiations among themselves, should it become apparent that the launching of the New Round by all contracting parties would be unfeasible. In this event, the benefits of trade liberalization would have to be extended only to these countries; countries which join later would be entitled the same benefits provided they assume the responsibilities and obligations agreed to by the original participants. In short, there would be a conditional, rather than unconditional, MFN principle in operation.

All previous GATT rounds were concluded in "one fell swoop",[8] that is, agreement on any given part of the agenda did not take effect until all agenda items had been considered. This approach is not likely to be adopted for the New Round. Instead, a rolling agenda will most likely be adopted, whereby agreement in one area could take effect without agreement having to be reached in other areas. The reason for this is that many governments are now under pressure to produce concrete results from these negotiations rather soon. Their legislatures, as well as their general public, would not have the patience to wait for concrete trade measures until the whole package has been agreed to. It should be noted that the implementation of the commitment to standstill and rollback alone would in effect be a departure from the "one fell swoop" approach during the negotiations.

Possible Benefits and Costs of the New Round

Assuming that the agenda and mode of negotiations outlined in the preceding section will be followed, the possible benefits and costs of each item for the developing countries in the Asian and Pacific region may now be considered. It is difficult to make an assessment for the whole region without undertaking major research. For this reason, the present assessment focuses on Korea. However, in principle, the analysis would also apply, with necessary modifications, to other developing countries.

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[8] Gary Hufbauer and Jeffrey Schott, *Trading for Growth: The Next Round of Trade Negotiations* (Washington, D.C.: Institute for International Economics, 1985), p. 90.

Arresting and Reversing Protectionist Trends. It is generally recognized that in recent years protectionist measures against developing countries have been on the rise. In the case of Korea, in 1974, only 25.3 per cent of its exports to the OECD countries were subject to non-tariff barriers. But by 1984, this percentage rose to 41.2 per cent.[9] It would not be unreasonable to assume that in the absence of standstill, this trend would not only continue but accelerate.

A standstill with "teeth" would have the effect of stopping this trend. In so doing, standstill would eliminate a major source of anxiety facing all traders, and thus greatly facilitate continued expansion of trade for all developing countries in the Asian and Pacific region.

It has been noted that if the New Round had been launched several months earlier and standstill put into effect, the United States probably would not have been able to renegotiate its existing bilateral textile agreements with Hong Kong, Korea and Taiwan. The magnitude of the benefits of standstill, then, can be gauged by estimating the losses resulting from the reduced access to the textile market in the United States. In the case of Korea, textiles and clothing still account for almost 25 per cent of total merchandise exports. As a result of its new bilateral agreement with the United States, Korea's yearly losses are estimated to amount to $212 million in 1986, $312 million in 1987, $382 million in 1988 and $463 million in 1989. As a percentage of total textiles and clothing exports, the losses represent 13.2 per cent, 15.5 per cent, 14.9 per cent, and 17.3 per cent, for 1986, 1987, 1988, and 1989, respectively.[10]

These losses in exports will no doubt impose great hardships on workers. Korea's experience in recent years has shown that each $1 million cut in exports would result in the unemployment of some 79 workers. Thus, the reduction of textiles exports to the United States will lead to the unemployment of at least 16,728 workers in 1986, 24,648 in 1987, 30,178 in 1988, and 36,577 in 1989. Given the labor intensiveness of textile and clothing manufacture, these figures underestimate the potential losses of jobs in the textile and clothing industry.

In regard to rollback, more than 41 per cent of Korea's exports to the OECD countries in 1984 were subject to various trade restrictions. According to an informal study done by the Korean government,[11] a hypothetical lifting of non-tariff restrictions on Korea's exports to its major markets in 1984 could have resulted in an increase in exports of \$1.2 billion,[12] 4.1 per cent more than the actual exports for 1984. This increase in exports would have created a significant rise in employment. Given that each \$1 million increase in exports in 1984 generated 79 jobs, the \$1.2 billion increase in exports would have led to the creation of as many as 94,800 jobs, or a 2.8 per cent increase in manufacturing employment for that year.

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[9] Korea Traders Association, *Overview of Import Restrictions of Industrialized Countries*, as cited in Chungsoo Kim, *Effects of Neo-Protectionism on Korean Exports* (Seoul: Korea Institute for Economics and Technology, 1986), p. 42.

[10] Based on estimates of the Economic Planning Board and the Ministry of Trade and Industry, Government of the Republic of Korea (1986).

[11] *Impact of Foreign Non-Tariff Barriers on Korean Exports*, an informal note prepared by the International Economic Policy Council, Government of the Republic of Korea (1985).

As for the impact on overall economic growth, the contribution of exports to overall economic growth in 1984 was 44 per cent. Given this ratio, a hypothetical 4.1 per cent increase in exports, adjusted for leakage into imports, would have resulted in additional GNP growth of 0.7 per cent, raising the GNP growth rate for that year to 8.2 per cent rather than the 7.5 per cent actually recorded. If we bear in mind that other developing countries also have a high ratio of trade to GNP, the hypothetical effect of rollback for Korea would in large measure be applicable to these countries.[13]

One export industry in which Korea would like to see rollback take effect is its steel industry. Under the terms of the voluntary export-restraint (VER) agreement with the United States negotiated in 1984, Korea is limited to a 1.9 per cent share of the market in the United States for steel. According to one estimate, Korea's steel exports to the United States would have grown by about 30 per cent in 1985 and by 25 per cent in 1986 if the VER had not been imposed in 1984 (see Table 1). Because such increases were not permitted — in 1985

Table 1: **Growth of Korean Steel Exports to the United States**

Item	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**[a]
Amount (\$ million)	410	595	435	696	925	882	924
Rate of Increase (%)		45.1	-26.9	60.0	32.9	-4.6	4.8

a Projected.

Source: Korea Steel Producers Association.

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[12] The benefits of rollback would be somewhat less than \$1.2 billion, because this estimate also includes the increase in exports resulting from a lifting of trade restrictions that are consistent with or based on GATT, such as anti-dumping and countervailing duties.

[13] According to IMF statistics, the ratios of commodity trade to GNP in 1984 for Hong Kong, Indonesia, Philippines, Taiwan, Thailand and Singapore were 90 per cent, 54 per cent, 16 per cent, 109 per cent, 51 per cent and 292 per cent, respectively.

Korea's steel exports declined by 4.6 per cent from 1984 levels – Korea's loss in steel exports to the United States for 1985 amounted to $321 million, or 1 per cent of total merchandise exports in that year. The loss in steel exports in 1986 could well rise to $580 million, or 1.7 per cent of total merchandise exports.

Improving Safeguards. Negotiating a comprehensive understanding on safeguards is perhaps the most crucial element in strengthening the GATT system and ensuring security of access to markets. Ideally, such an understanding should include: (i) a clarification of the circumstances under which Article XIX can be invoked; (ii) a requirement for phasing out emergency action; and (iii) a provision for compensation or retaliation. Furthermore, safeguard action should not be selective but rather should be taken on the basis of nondiscrimination. For such an understanding to be effective, it would perhaps be necessary to establish a safeguard surveillance committee.

However, it would be unrealistic to expect that a complete understanding could be reached. In all probability, there would have to be some relaxation on the requirement to pay compensation. As noted earlier, this requirement has been responsible in large measure for the tendency of many contracting parties to adopt "grey-area" measures. If a relaxation in this requirement could reduce the use of such measures, the GATT system would be greatly strengthened. Furthermore, placing a time limit on emergency action would be conducive to structural adjustment. Strengthening the GATT system and facilitating structural adjustment would, in turn, greatly promote the expansion of world trade.

The benefit of improved safeguards would be substantial, particularly for the developing countries in the Asian and Pacific region. For example, if the so-called principle of "selectivity" could be permanently shelved in the course of the New Round, relatively advanced developing countries such as Hong Kong, Korea, Taiwan and Singapore would enjoy the greatest benefit; after all, they are precisely the countries that the advocates of selectivity have had in mind as their principal targets.

Bringing Trade in Agricultural and Tropical Products under GATT. Most of the developing countries in the Asian and Pacific region depend heavily on agricultural exports (see Table 2). For this reason, they would gain a great deal if their agricultural exports would increase as a result of an agreement achieved in the New Round to bring trade in agricultural products under greater GATT discipline. Agreement is likely to be reached first on reducing export subsidies. This alone should greatly eliminate distortions in world trade in agricultural products.

It is worth noting the results of a recent study on the effects of distortions in agricultural trade.[14] According to this study, total liberalization in

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[14] R. Tyers and K. Anderson, *Distortions in World Food Markets: A Quantitative Assessment,* Background Paper for the *World Development Report 1986* (1986).

Table 2: **Share of Agricultural Exports in Total Exports, 1984**

Country	Total Merchandise Exports ($ Million)	Agricultural Exports ($ Million)	Percentage Share
Indonesia	21,145	3,296	15.6
Malaysia	4,917	1,915	38.9
Philippines	6,308	3,948	62.0
Thailand	14,117	5,962	42.2

Sources: International Monetary Fund, *International Financial Statistics* (1985); and Food and Agriculture Organization, *Trade Yearbook* (1985).

agricultural products effected by all countries would increase the share of developing countries in world exports of rice from 67 per cent to 88 per cent, of ruminant meat from 22 per cent to 59 per cent, and of sugar from 72 per cent to 96 per cent. Such increases should be of great benefit to countries such as Indonesia, Philippines and Thailand.

Among the developing countries in the Asian and Pacific region, the country that is likely to face the most serious difficulties of adjustment if trade in agricultural products were liberalized rapidly would be Korea. Singapore and Hong Kong have no significant agriculture sector and Taiwan's agriculture sector already has been liberalized to a great extent. Although Korea already meets over 50 per cent of its needs for agricultural products through imports, it still has a long way to go in restructuring its agriculture sector in line with its comparative advantage. Japan will face similar difficulties. Given the political sensitivity of agriculture as well as the slowness of mobility of resources to and from agriculture, the restructuring process would have to be gradual. As long as these countries are given enough time, the cost of adjustment could be minimized.

Phasing Out the Multi-Fiber Arrangement. Currently, there is a widespread feeling among both developed and developing countries that MFA IV should be the last MFA. Given this feeling and the need to establish credibility for the New Round, it is likely that countries will agree to a phasing out of restrictions after the MFA expires in 1991. The benefits of such a phase-out are suggested by the earlier assessment of the benefits of a hypothetical standstill on bilateral textile restrictions.

If the textiles trade were to be brought under GATT rules and principles, there would be a substantial redistribution of production away from developed countries to developing countries. Similarly, there would be a redistribution of production and exports among developing countries in favor of those with low-cost production and better marketing skills, many of which would be small suppliers and new entrants. In addition, the uncertainties facing potential investors would be reduced, and this, in turn, would go far towards stimulating industrialization in the poorer developing countries.

Reducing Tariff and Non-Tariff Barriers. Considering that the average tariff rates of developed countries are very low, future tariff reductions cannot be expected to result in substantial trade expansion.[15] In addition, it must be anticipated that some tariffs will re-emerge in the process of converting current non-tariff barriers into tariff equivalents.

This does not mean, however, that future tariff reductions will have no effect at all. In fact, the reduction of high rates on particular commodities will not only increase trade in these commodities but will also enhance the efficiency of resource allocation in all economies. Furthermore, alleviating the problem of tariff escalation on finished manufactured goods in the major industrialized countries will discourage excessive backward linkages in these countries and promote industrialization in the resource-rich developing countries.

Today major trade barriers take the form of quantitative restrictions. Therefore, a lifting of these restrictions would significantly stimulate world trade in two ways. First, the elimination of quantitative restrictions inconsistent with GATT would amount to a complete rollback, the benefits of which have already been discussed. Second, the lifting of other quantitative restrictions would contribute to the expansion of world trade.

Refining the Anti-Dumping and Subsidies Codes. In order to bring national anti-dumping and countervailing duty practices under stricter international discipline, trading parties that do not obtain satisfaction from national authorities should be allowed to bring their cases to a GATT panel with power to arbitrate.

Such a procedure would discourage less competitive suppliers to use anti-dumping and countervailing suits as an instrument of harassment against the most efficient, fair trading suppliers. This would have the salutatory effect of eliminating a great source of uncertainty which currently confronts investors in the most competitive export industries. Furthermore, refining these two codes would increase the transparency of anti-dumping and countervailing duty actions, thus contributing to the orderly expansion of trade.

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[15] For a differing view on the impact of further global tariff reductions, see A. Deardorff and Robert Stern, "The Economic Effects of Complete Elimination of Post-Tokyo Round Tariffs", in William Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983).

Institutional Strengthening of GATT. It is clear that steps to improve dispute settlement procedures and to give greater decision-making power to GATT would greatly benefit the developing countries. Specifically, if GATT panels were reinforced and empowered to arbitrate trade disputes, the process would be far less time-consuming and fewer countries would ignore GATT recommendations. Converting GATT from an agreement to a formal treaty organization would encourage GATT member countries to move away from a consensual decision-making process, thereby enabling it to make effective policy decisions in a timely way.

In the absence of such steps, GATT would continue to weaken as an organization. Thus, the multilateral trading system would be eroded, and either bilateralism or a system based on regional trading blocs, or both, would take its place. Furthermore, the system of trade based on law would be reduced to one based on power.

Under bilateralism, developing countries would not only lose the benefit of non-discrimination based on the MFN principle but would also be put in an extremely disadvantageous position in terms of bargaining power, particularly vis-à-vis the large industrial countries.[16]

Under regionalism, the interest of most of the developing countries would be subordinated to those of larger countries, which will become the power centers in any regional arrangement. And because regionalism involves discrimination between members of the bloc and non-members, it would generate uneconomical trade diversion from which both developed and developing countries would suffer equally.

The benefits of a system of trade based on the rule of law over one based on power for developing countries are also very obvious. Under a system based on power, world trade is likely to be managed at the whim of countries which hold power. With very few exceptions, developing countries do not enjoy such power, and as a result, their interests would invariably be sacrificed for the benefit of the powerful countries.

The dictum that the poor and powerless need the protection of law much more than the rich and powerful applies to relations between trading partners as with relations between individuals. Only under a system of law can small developing countries expect to have a fair chance of bringing a case against a large developed trading partner should a dispute arise between them. Only under a system of law based on multilateralism can the developing countries, individually or collectively, expect to enforce discipline on powerful developed countries. And only then can they depoliticize trade and derive maximum benefit from it.

The Issue of Special and Differential Treatment for Developing Countries. As already noted, the developing countries will probably be asked in the course of the New Round to give up or at least modify the special and differential treatment they are currently receiving under Part IV and other provisions of GATT. A major benefit to developing countries of taking either step would be that the MFN principle, and therefore the multilateral trading system, would be greatly strengthened. It would enhance international discipline over national trade policies and foster the kind of open markets in which all countries, especially developing countries, have an important stake.

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[16] For insightful discussions on the benefits of a multilateral trading system without preferential treatment for developing countries, see Brian Scott, *op. cit.*, and Lawrence Krause, *op. cit.*

In regard to the costs of giving up special and differential treatment, three issues are involved. First, the advanced developing countries are likely to be asked to give up their benefits under the Generalized System of Preferences (GSP). Second, it will probably be suggested that these countries refrain from resorting to quantitative restrictions to deal with balance of payments problems. Third, the question will be raised as to whether advanced developing countries will be entitled to pursue a set of policies designed to help infant industries.

One study suggests that if Korea had graduated from all GSP schemes in 1983,[17] the loss in exports would have been about $332 million,[18] or about 9 per cent of the value of total GSP exports to the OECD countries in 1983 and 1.1 per cent of Korea's total merchandise exports to the world that year. The reason why the elimination of GSP would have such a relatively small effect is partly because of low average tariff rates currently in effect in the developed countries. As these rates have been whittled down in the course of the previous trade rounds, so have GSP preference margins.

The cost of graduation from GSP should also be weighed against two considerations. First, the GSP was originally adopted to stimulate industrial development in developing countries. It should, however, be remembered that achieving this objective also carries a cost. By trying to benefit from GSP, a developing country locks up valuable resources in industries in which it may not have comparative advantage, thus leading to the misallocation of resources. In so doing, the country may lag behind in developing new industries with good growth prospects. In addition, developed countries could use the GSP as an excuse for the discriminatory treatment that they currently extend to developing countries in the form of the MFA, VERs and "orderly marketing arrangements" (OMAs). As noted earlier, these trade restrictions may have led to losses in Korean exports close to $1.2 billion in 1984.[19] If this discriminatory treatment could be traded off against the benefits of GSP, developing countries could be better-off by a great margin.

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[17] *The Effects of Graduation from the Generalized System of Preferences on Korea's Exports*, an informal note prepared by the International Economic Policy Council, Government of the Republic of Korea (1984).

[18] The decrease in the value of exports resulting from graduating from each GSP scheme was computed as the product $a \times b \times c$, where a is the value of Korea's GSP exports to a preference-granting country, b is the increase in the average weighted tariff of the preference-granting country resulting from the graduation of Korea, and c is the price elasticity of demand for Korean exports of the preference-giving country.

[19] Again it should be kept in mind that the $1.2 billion figure overstates the gain from rollback, since it is the estimate of the gain from a lifting of all non-tariff barriers to Korea's exports in its major markets.

Similarly, developing countries should re-examine their entitlement under Article XVIII in resorting to direct controls on current account transactions as a way of solving balance of payments problems. In any country, these problems may best be dealt with through the realignment of the exchange rate and appropriate monetary and fiscal policies. Such macroeconomic policy instruments can bring about balance of payments equilibria without distorting the composition of trade.

It is in the area of pursuing policies to help infant industries where the cost of giving up special and differential treatment could be greatest for developing countries. As long as their capital markets are inadequate and there is a need to exploit the externalities that arise from dynamic economies of scale, developing countries will pursue policies to promote infant industries. In the New Round, this development need should not be compromised.[20]

To argue for this is not to suggest that the promotion of infant industries should be across-the-board and permanent. The argument is rather for the careful selection of industries entitled to protection as well as the requirement that such protection be time-bound and degressive. As long as these aspects are given due recognition by developed countries in the course of the New Round, developing countries should have little cause to reject outright the suggestions by developed countries to modify special and differential treatment for developing countries in a substantial way.

Establishing a Framework of Rules for New Issues. It has been fashionable to argue that negotiations on services will be only to the advantage of the developed countries. This argument is based on two implicit assumptions: (i) that the developed countries have comparative advantage in all sectors of services; and (ii) that most services that have been discussed in connection with the New Round are still in their infancy in developing countries. The first assumption is not necessarily the case. For example, Korea enjoys comparative advantage in service sectors such as construction, medical services and commercial aviation. Thus, if these sectors were liberalized, the country would gain immensely.

It can be argued that in fields such as banking, insurance, computer services and telecommunications, the developed countries hold comparative advantage vis-à-vis the developing countries and that most of these industries are in an infant stage in developing countries. The fact that these are infant industries in developing countries does not constitute sufficient grounds for them to refuse negotiating to bring services under GATT rules. Rather, the argument is that in liberalizing trade in these sectors, these industries should be treated in the same way as infant industries in other sectors of the economy, i.e., protection to these industries should be time-bound and degressive.

The concern that national treatment to foreign concerns in several services sectors could undermine a government's ability to promote economic development is misplaced. National treatment in services such as banking, insurance and telecommunications is not synonymous with the abrogation of the power of government to regulate these industries. For example, allowing foreign banks to do business on the same terms as domestic banks does not mean that the national government is giving up its authority over monetary and financial policy.

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[20] For a similar view on this subject, see Lawrence Krause, *op. cit.*

There is another important point yet to be made in regard to the liberalization of services. The developed countries have argued for the liberalization of services that are capital-intensive and technology-intensive. In so doing, the industrially advanced countries are in effect arguing for greater international mobility of capital and technology than that of labor. Meanwhile, developing countries seek to promote freer trade in services that are labor-intensive. In principle, it makes little sense to argue for greater mobility of capital and technology across national boundaries than for labor, because as factors of production, they should enjoy equal mobility for greater efficiency in the allocation of resources worldwide.

Given the inseparable link that exists between trade in goods and services and investment in today's world, the liberalization of trade cannot be separated from investment policies. For this reason, the developing countries should not object to including foreign investment in the agenda for the New Round. Rather, they should have a real interest in liberalizing their foreign investment policies. Considering their heavy indebtedness, many of these countries can no longer hope to finance further investment by borrowing from abroad as in the past. At present, a greater inflow of foreign investment is the only means that will allow them to undertake investment beyond the level that can be adequately financed through domestic savings. Without liberal investment policy regimes, any efforts to induce foreign investment would produce unsatisfactory results. Only a liberal investment regime would bring in foreign investment, by maximizing transparency and minimizing uncertainties facing potential investors.

The developing countries have expressed two major concerns on intellectual property: (i) that protection of intellectual property yields benefits only to the developed countries; and (ii) that there already exist organizations that provide adequate protection of intellectual property rights and, hence, that GATT has no role to play in this area. The first concern assumes either that technological progress can take place without incentives made possible by protection or that a developing country will always remain dependent on the technologies supplied by developed countries. Obviously, neither of these assumptions is valid. The developing countries should recognize the economic benefits flowing from the adequate protection of intellectual property. In regard to the second concern, despite the large number of organizations, enforcement has been less than adequate, and insufficient attention has been paid to the trade distorting effects of laxity in enforcement. The GATT should be allowed to work with these organizations to provide more adequate protection of intellectual property, especially when goods and services enter international trade.

Concluding Remarks

The agenda for the New Round will undoubtedly include items of great interest to developing countries in the Asian and Pacific region. For example, standstill and rollback would be of immense benefit to these countries. An improved safeguards system and the application of GATT rules and principles to trade in agricultural products and textiles and clothing would greatly increase their trade opportunities. And the strengthening of the GATT system would, on balance, benefit developing countries more than developed countries. These issues, if resolved, would contribute significantly towards increasing free trade throughout the world.

The agenda of the New Round is likely to include "new" items which, at first glance, may appear costly to developing countries. But they would also involve benefits for these countries. The New Round should be considered as an opportunity for both developed and developing countries to cooperate in solving each other's problems. If the New Round were to include only issues of interest to developing countries, developed countries would have very little incentive to take part in the New Round. The inclusion of both old and new issues, therefore, increases the probability of a successful outcome for trade negotiations.

The Asian and Pacific region is the most dynamic region of the world, and the developing countries of this region currently enjoy the greatest growth potential, which can best be realized through the expansion of world trade. In this connection, it is worth recalling that many developing countries of the Asian and Pacific region, such as Korea, Singapore and Taiwan, experienced annual growth rates of 10-12 per cent during the period 1965-1973, when world trade was relatively free. But their growth rates dropped by more than one-third to 6-7 per cent during the period 1975-1983, when protectionism intensified.

The renewed expansion of trade will have a multiplier effect not only on the economy of one country but also on other economies. The growth of a country's exports will lead to higher economic growth and income which, in turn, will generate demand for imports from other countries. At the same time, other countries will also experience export and income growth; the growth of income in these other countries will, in turn, generate demand for exports from the country concerned, thus sustaining each other's rapid economic progress. Apart from this mutually reinforcing effect, the expansion of world trade serves as the most powerful vehicle for transmitting technological and managerial know-how among countries, thus raising allocational efficiency for all.

It is through such dynamics of growth that developing countries in the Asian and Pacific region will best be able to meet their current internal and external challenges. In most of these countries, the labor force increases more rapidly than population. Furthermore, with rapid economic growth in the past two decades, expectations for a better life in these countries are rising faster than the pace of economic growth. Thus, there is a real danger that unless these expectations are met, serious social and political instability could ensue, which can best be prevented by rapid economic growth made possible through an expansion of trade based on a sound multilateral trading system.

The overall benefits of a successful New Round will be greatest for developing countries in the Asian and Pacific region for another reason. It is well known that the potential gains from international trade are larger for the smaller and less-developed countries. Most of the developing countries in this region are in this category. In addition, these countries must continue to diversify their export markets. In the absence of a successful round of multilateral negotiations, it will be difficult for their efforts to bear fruit.

Admittedly, there are costs to be borne by developing countries in taking an active part in the New Round. Participating in the trade talks and adhering to the outcome implies some loss of independence in policymaking. But this is a price that a country should be willing to pay in exchange for the benefits to be derived from a system based on the rule of law. In addition, there would be substantial costs associated with the need for structural adjustments related to trade liberalization. Fortunately, such costs are relatively small for developing countries in the Asian and Pacific region. For many countries, their economies are in the early stages of development, with few of the structural rigidities that characterize more advanced economies. Furthermore, since these developing countries are growing more rapidly than those in most other regions, they are in a better position to accommodate necessary structural changes. It is therefore important for developing countries in the Asian and Pacific region to take the lead in the New Round of multilateral trade negotiations.

Trade between Asian Developing Countries: Record and Prospects

Burnham O. Campbell*

Recent developments along with the dynamics of growth suggest that trade between developing countries must expand if they are to achieve satisfactory rates of economic growth. This is so, even though in a free trade world, there may be no benefits in directing trade one way or another. Left to the market, trade will follow demand along lines of comparative advantage. However, when protection is present, when markets are not alike in marketing infrastructure, tastes differ, and demand is growing at different rates in different parts of the world, policy steps may be necessary to gain the maximum advantage from trade, including those designed to increase trade among specific groups of countries. In this article, emphasis will be on one of these groups, the Asian developing countries.[1]

Essentially, the argument is simple. If protection is actually or perceived to be growing in the industrial countries or if the growth rate of gross national product (GNP) is slowing secularly (or simply stabilizing at present levels) in these countries, then to maintain the same overall rate of growth, trade with some other group of countries will have to grow more rapidly. Increased trade, roughly along lines of comparative advantage, increases productivity and so leads to growth in per capita income. Secularly increasing trade then helps maintain growth in per capita income as long as specialization increases efficiency. In a dynamically changing world there is no end to this process.[2] While achieving such increased efficiency in the context of a world free trade system is the optimum situation except in very rare circumstances, if this is not possible because of the reasons suggested, then increasing efficiency through free trade over a part of the world is a better alternative than autarky or trade constrained to an unchanging comparative advantage. And for individual Asian developing countries, increased trade with other Asian developing countries seems the most viable alternative if developed country markets fail to expand as rapidly as they have in the past. The size and vulnerability of Middle East countries rule out these ex-capital surplus oil exporters as a source of increased trade in the long

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[1] The discussion in this article, however, refers to only those countries for which relevant data are available.

[2] This differs from considering exports as an "engine of growth". Expanding exports can raise GNP in pace with the growth in available resources. This can maintain growth rates (if exports increase at a constant rate, so will GNP) but will not increase per capita income.

run. The continued poor economic performance and trading preferences of all the "centrally planned" economies, with the possible exception of the People's Republic of China, rule out this source of export growth. Supporting the emphasis on trade between developing countries is the difficulty most countries just beginning the industrialization process face in keeping up with the rapid changes in the markets of the industrial countries. The costs of adapting to these changes and the effects of the cyclical instability they create tend to make enhanced trade with countries at similar stages of development more attractive. However, there are almost universal constraints on such trade; both tariff and non-tariff barriers are higher in developing countries, including those in Asia, than in most industrial countries, especially members of the European Economic Community (EEC) and the United States.[3]

For some time to come, this dependence on growth in intra-developing country trade may not be so apparent. The industrial countries remain relatively open, and there are no limits to the commodity markets in which developing countries can compete. The view that developing countries have no further options after simple labor-intensive techniques and slightly fabricated primary products have been fully exploited has long been disproved (e.g., in Brazil, India, Republic of Korea and Taiwan). However, exports of developing countries to industrial countries cannot indefinitely continue to increase more rapidly than the growth rate of these countries. Such exports can, as in the 1960s and 1970s, displace production in industrial countries, but a limit will soon be reached. Moreover, at some stage, displacement must be at the expense of other developing countries. The expansion of developing country exports to industrial countries will then depend on sharing in the growth in demand in such countries. Based on their past performance, the Asian developing countries, especially the Newly Industrializing Countries (NICs) and member countries of the Association of Southeast Asian Nations (ASEAN),[4] may be the short-run "winners" in any competition for shares in industrial country markets, but in the long run they too must reach the growth rate limit. The secular slowing growth of industrial countries, brought about by the "catching up" of some and changing demography of others, will ultimately limit the growth of developing country exports to industrial countries.[5] The limits will be met sooner if the effect of slowing growth is translated into a general increase in protection in industrial countries.

Clearly, if developing countries are to achieve continued high rates of economic growth, they must expand their exports at or near the rates attained in the 1960s and 1970s. The possibilities for economies of scale, specialization and learning-by-doing, and exchanges based on relative productivities are far too limited domestically for most developing countries to make headway without export growth. And as indicated earlier, the only way for expansion at the rates desired will be through increased trade between developing countries. Given that such trade is now the most constrained by trade barriers, changes in the commercial policies of these countries are necessary. Hopefully, this can be achieved in the context of changes that would expand total trade – e.g., under the General Agreement of Tariffs and Trade (GATT) – but partial replacement of industrial country imports by those from other developing countries could also raise growth rates in developing countries.

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[3] Dean A. DeRosa, "Trade and Protection in the Asian Developing Region", *Asian Development Review,* vol. 4, no. 1 (1986), pp. 27-62.

[4] The NICs include Hong Kong, Republic of Korea, Singapore and Taiwan. The member countries of ASEAN are Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. However, in this article Brunei is excluded because of a lack of relevant data. And, for purposes of analysis, Singapore is excluded from the ASEAN group of countries, also referred to here as Other ASEAN.

[5] Aging populations may slow economic growth, but they will place more emphasis on consumption and could reduce protectionist pressures.

The evidence points to the potential for expansion of trade between developing countries. Table 1 shows that from the 1960s, growth in developing country exports has been greater than in industrial country exports and, thus, greater than the growth in world trade. More important, growth in inter-developing country trade exceeded the growth of exports from developing countries to industrial countries between 1960 and 1984. Partly, these outcomes reflect the slower growth of industrial countries in general and, partly, they reflect secular growth in inter-developing country trade. The latter is especially true for Asia. The total share of Asia in inter-developing country trade increased significantly, especially intra-Asian trade. The higher economic growth rate in Asia accounted for much of this outcome. The fact that these increases occurred despite the prevalent trade barriers and helped to mutually reinforce regional growth suggests the possible value of policies designed to further open up the markets of Asian developing countries.

For trade between developing countries to grow as required, some policy changes will be necessary. As growth in demand from industrial countries slows, inter-developing country trade will not make up for the slowdown because the protection in place will prevent an increase in such trade. Efforts to substitute domestic demand growth for industrial country growth will not succeed because the required self-sustaining expansion in trade will not be stimulated. There are many options, with reciprocally negotiated free trade zones possibly best for political reasons. However, there are also other problems, such as a lack of established marketing structures or channels in developing countries and a possible bias in transportation against such trade. Thus, intervention – to finance exports, develop shipping conferences, and establish distribution channels – may be required where social benefits exceed private gains.

However, when the possibility of increased inter-developing country trade or reduced barriers between such countries is raised, the same arguments emerge. Generally, the conclusion is that developing countries, especially in the same region, are so alike that they cannot trade because they are "competitive" rather than "complementary". However, the differences between developing countries are greater than between industrial countries, yet trade among industrial countries is relatively greater and continues to increase. This raises the issue: What determines the extent and direction of trade?

Table 1: **World, Industrial Country, and Developing Country Exports**
(Percentages)

Years	Growth Rates of Exports					Share of Exports			
	World to World	Industrial Countries to World	Non-Oil Dev'g Countries to World	Non-Oil Dev'g Countries to Industrial Countries	Non-Oil Dev'g Countries to Non-Oil Dev'g Countries	Years	Dev'g Asia Exports to All Dev'g Countries/ Dev'g Asia Total Exports	Dev'g Asia Exports to Dev'g Asia/ Dev'g Asia Total Exports	Non-Asian Exports to All Dev'g Countries/ Non-Asian Dev'g Country Total Exports
1969-1971 to 1972-1974	25.1	23.1	25.1	24.6	24.7	1970	29.5	19.1	21.8
1972-1974 to 1975-1977	17.8	16.0	18.3	16.7	18.6	1984	37.3	26.9	26.4
1975-1977 to 1978-1980	18.2	18.0	19.7	18.4	23.3	1970-1984	7.8	7.8	4.6
1978-1980 to 1981-1983	4.4	3.6	9.3	7.0	12.6				

Sources: United Nations Conference on Trade and Development, *Handbook of International Trade and Development Statistics, 1985 Supplement* (New York, 1985); International Monetary Fund (IMF), *Direction of Trade Statistics Yearbook* (Washington, D.C., 1985 and various issues).

This article addresses this issue by examining the present status of trade among Asian developing countries and explores the basis for increased trade between them.[6] It first sets out the most widely accepted explanations of the basis and determinants for trade. It then reviews the characteristics of the Asian developing countries in relation to these determinants and traces the implications for trade between these countries. Next, it discusses the empirical evidence covering the direction of trade between Asian developing countries and between them and industrial countries, with special attention to intra-regional and intra-industry trade among the Asian developing countries. Finally, it summarizes the basic issues raised and outlines the likely development of trade between Asian developing countries.

The Basis for Trade: Possible Explanations

There are several distinguishable reasons for mutually advantageous trade. They sometimes overlap, being of different levels of generality, but each has an important place in the trade literature and helps to suggest what may be expected in trade flows between countries.

One explanation of trade is that countries with different relative factor endowments will have different no-trade production trade-offs and so a basis for gains from trade. Left alone, without barriers, markets will take advantage of these trade-offs, capturing the gains. This explanation of trade patterns — the traditional Heckscher-Ohlin trade theory — focuses on relative endowments of capital and labor. In its "pure" form, it assumes constant returns to scale, open access to an equally known world stock of knowledge, and no country-specific specialized resources or factors of production.

In the Heckscher-Ohlin framework, it is useful to distinguish human from physical capital and to recognize that relative factor endowments are not static. They can and do change with the accumulation of physical and human capital and with population growth and associated changes in the age and skill composition of the labor force. In addition, changes in the "stock of appliable knowledge" are another source of changed resource endowments.

The fact that the endowment of factors, absolute and relative, is not fixed essentially means that domestic policies, e.g., any that affect the savings ratio, the capital/output ratio, the amount and kind of education, or any that "distort" relative prices, will also affect the Heckscher-Ohlin-based comparative advantage and, in turn, the composition and direction of a country's trade.

In the dynamic Heckscher-Ohlin context, the stage of development is then a proximate determinant of the factor composition of a country's trade. The expectation is that a country will trade commodities with partners higher on the development ladder that are less capital (physical or human) intensive than their average factor endowment. And, with countries lower on the ladder, they will trade commodities that are high on their capital intensity spectrum. Domestically (or with countries at a similar development stage), they will trade commodities closer to their national factor endowment.

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[6] For a rather different analytical approach, see Oil Havrylyshyn and Martin Wolf, *Trade among Developing Countries: Theory, Policy Issues, and Principal Trends,* Staff Working Paper, no. 479 (Washington, D.C.: World Bank, 1981).

If one (or more) of the basic assumptions of the Heckscher-Ohlin explanation of trade is excluded, then other factors become important in explaining trade patterns. For example, if it is recognized that many resources are place-specific and cannot, with time and savings, be reproduced everywhere, then another source of trade, so-called Ricardo goods, emerges. There are differences in the amounts and qualities of mineral resources available, in the quality (arability and productivity) of land, in the quantities of different qualities of land, and in the natural environment between countries. Trade based on these differences is possible even among countries with very similar capital/labor ratios and should be an important source of trade between developing countries at roughly similar stages of development.

Similarly, if it is assumed that new technology is not immediately available everywhere, but spreads with time from the country with proprietary rights (the initiating country) to others, then there is a basis for "product cycle" goods. Essentially, these are goods requiring particular knowledge as a basic input and factor proportions not too far out-of-line with those in the country initially acquiring the knowledge (or the knowledge will be employed elsewhere). As the knowledge is exploited, three things happen that tend to make the industry move about the world.[7] First, the basic knowledge becomes more widely available. Second, factor proportions change away from those required in the initiating country. Third, factor proportions change toward those required elsewhere. Obviously, there is a close relation between product cycle goods and dynamically based Heckscher-Ohlin goods.

Further, if we allow economies of scale or the achievement of cost advantages by experience or learning-by-doing, then we have a basis for trade between countries that are similar in all other respects. This helps to explain the observed large amounts of intra-industry trade between relatively similar countries (e.g., EEC countries, Canada and the United States). Here, the race goes to the fast starter in any particular endeavor and so often has a significant historical and policy input, though it would seem that the numerous opportunities for developing small businesses based on seemingly minor product differences would be more likely taken up where trade is open and competition is the rule. In countries at similar stages of development and with similar demand configurations (tastes), there are likely to develop many products meeting each other's needs. The way this is determined for specific products is unpredictable, except that if policy allows the development of all the support and end products of a particular industry some of these are likely to be competitive in similar countries.

This last source of trade raises the possibility of policy intervention to achieve economies of scale and/or experience. For such steps to work, the international market must be large enough to accommodate both local and foreign suppliers at a profitable rate when the experience is gained or the optimal rate of output is achieved. Otherwise, the country may be locked into a costly, low-productivity, low-growth activity. Picking winners is difficult and getting rid of losers is even more difficult. This also applies to interventions to take advantage of where the country will be in factor endowments. Interventions can work, especially where economies of scale and/or experience are important sources of cost advantage (e.g., the automobile industry in the Republic of Korea), but it is exceptionally costly in the short run to the country's consumers and a gamble in the long run (e.g., the shipbuilding industry in the Republic of Korea) for governments to attempt to direct resources in this manner. Setting the stage for the competitive working of the market to lead the way by providing the necessary institutional framework could still be the most effective *and* efficient approach.

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[7] Assuming low transport costs for material inputs or their availability in or near the "host" country.

In any event, governments *will* try to substitute their decisions for those of the market, and the pattern of trade that would be expected at any time based on other considerations (e.g., our Heckscher-Ohlin and Ricardo categories) will be distorted by government interventions in the form of commercial policy. This pattern will also be affected by the fiscal, monetary, exchange rate, and allocative policies in other countries. These affect the relative prices faced in different countries and, thus, the comparative advantage. In the short run, and especially if balance of payments equilibrium is not imposed, relative demand and demand growth conditions can move trade away from the pattern resulting from relative resource endowments. The policy environment is clearly a major determinant of observed trade patterns.[8]

In sum, the pattern of trade, the composition of exports, and the direction of exports depend on both supply and demand. And the determinants of supply and demand are continually changing. Resources are depleted or made obsolescent by technological change. Capital, both physical and human, accumulates, changing the relative costs of production, and is made obsolescent by technological changes (and changed factor endowments) elsewhere. Costs fall as output expands and experience is gained. Knowledge accumulates, bringing innovations or technological breakthroughs. The size and the age and sex composition of the population change, altering the relation between labor and physical capital and the stock of different kinds of human capital. Finally, policies and institutions change. The upshot is that comparative advantage is ever-changing. At anytime, by definition, every country has a comparative advantage. But the question that policymakers must face is: How long will the current comparative advantage last? To encourage trade with public resources, along the lines of comparative advantage, may be wasteful if after much new investment and before major returns occur the basis for trade suddenly changes. There are no answers, but it may be best to let those who are prepared to risk their own resources make the key decisions.

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[8] Other factors influencing trade patterns are transport costs and marketing institutions and networks. These, especially the institutional environment in the trade sector, are factors often overlooked in comparing country opportunities.

Trade among Asian Developing Countries: Determining Characteristics

Before examining the trade patterns and assessing the prospects for trade of Asian developing countries, it will be useful to roughly ascertain which countries would be expected to export particular classes of Heckscher-Ohlin goods, where the advantage in Ricardo goods lies, at which levels countries are likely to be in the product cycle hierarchy, which countries have an advantage in terms of size of domestic markets and/or experience, and what has been the impact of the policy milieu. This is attempted here, using indices based on the relation of each country's standing to the average standing for the entire group.[9]

In terms of Heckscher-Ohlin goods, two indices are used (see Table 2). The first is the physical capital/labor ratio, an index that ranks countries in terms of their comparative advantage in producing more or less capital-intensive goods. The higher this ratio, generally, the more productive labor will be and so per capita income will be higher. Most other indices of development should be correlated with this ratio, especially those related to the product cycle. But as noted earlier, physical capital is only one factor. Human capital, based on a combination of education and work experience, is also important. For the levels of technology mostly involved – though they are changing – the key relations are the proportion of the labor force classified as professional and technical and the current educational effort at the secondary school level.

As expected, the industrial countries, used as a benchmark, have much higher physical capital/labor ratios than any of the developing countries, except for Singapore and Hong Kong. However, the great differences between the Asian developing countries are most striking. Clearly, there is much scope for trade based on Heckscher-Ohlin differences between these countries. Classifying the first group as physical capital-intensive, the next group includes Taiwan, Republic of Korea and Malaysia as borderline cases. They are still, on average, far from being competitive in producing the highly capital-intensive goods based on the given factor endowments (except for the Republic of Korea which has deprived some less capital-intensive sectors by allocating capital to highly capital-intensive industries). Far behind, and essentially still comparatively efficient in the production of labor-intensive goods, are the Philippines, Thailand, Indonesia and Sri Lanka. The next group includes the very labor-intensive economies of South

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[9] Thus, the indices are best interpreted as measures of the relative rank of the countries included with some weight given to the gap between ranks. If it had been possible to decide, say, that x amount of arable land per capita is required to have the agricultural flexibility to be dominantly an agricultural exporter, then that amount of land per capita could have been used instead of the country average as the base for the country indices of arable land per capita. Since this was not possible in most instances, the average value was used. The result, which requires care in interpretation, is that an index below 100 may go to countries, on some characteristic or other, that have far surpassed the absolute value for meeting some subclass (e.g., Ricardo good exporter and capital-intensive producer) of the characteristic.

Leamer's approach to measuring resource endowments, at least for Ricardo goods and Heckscher-Ohlin goods, is similar to that used in this article. However, there are important differences, especially in measuring human capital and in country coverage. See Edward.E. Leamer, *Sources of International Comparative Advantage, Theory and Evidence* (Cambridge, Mass.: MIT Press, 1984).

Asia (as in the case of the Republic of Korea, because of capital allocations this ratio hides the fact that there are some very highly capital-intensive industries in these countries, especially in India). These standings indicate the status of trade and domestic production if there were no interventions. In fact, the countries at the top of the table still support (subsidize or protect) labor-intensive industries just as those at the bottom have encouraged capital-intensive production.

The human capital index gives a ranking similar to the physical capital index. However, there are some interesting exceptions. For example, taking the secondary school Index A first, Singapore, New Zealand and Hong Kong are below the Republic of Korea and Taiwan on this criterion, which has implications for the future. Also, much higher than on the physical capital/labor ratio are the Philippines and Sri Lanka. Both could be said "ready" for rapid development, especially of product cycle goods if other policies are right. For those countries at the bottom of this ranking, labor-intensive manufacturers using the simplest of skills or learned through "tradition" are likely to remain the basis for industrial comparative advantage until the educational effort is increased.

Turning to Index B, which relates enrollment in professional and technical schools to the 20-24 age-group population base, the differences are still more striking. On this indicator of "readiness" for high-technology activities and technological transfer, including transfers of management skills, Hong Kong and Singapore fall even farther behind the other NICs.[10] Perhaps more significantly, though advantage has yet to be taken of the opportunity presented, the Philippines ranks higher on this index than other Asian developing countries and ahead of Australia and New Zealand. Also significantly, Thailand ranks close to the Republic of Korea and far ahead of the other Asian developing countries, all of which do not have the same "preference" for professional and technical education. Given the achievement of Thailand and the Philippines, this is not solely a matter of lower income.[11]

The physical and human capital-intensive ranking of the countries in Table 2 follows closely usual notions of ranking in terms of stages of economic development. When the rankings in terms of Ricardo goods, either arable land per worker or the proxy for mineral wealth, mineral production per worker, are compared with this ranking, the outcome is very different. Having natural resources does not guarantee having a high per capita income. If there is any tendency, it is the opposite, but there are too many exceptions for easy generalization.

Excluding Australia, in terms of agricultural commodities, the countries with indices of 110 or above, on other evidence, appear to have the base to be net

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[10] There are no comparable data for Taiwan, but other information suggests Taiwan would be below the Republic of Korea though not by far.

[11] Indonesia and India, even with indices shown, because of their large size, will educate in absolute numbers at least a "critical mass" of professional and technical people. However, in the long run, the interests of these people would receive much less attention than in countries where they form a much larger part of the total population.

Table 2: **Determinants of Trade: Indices of Key Factors for Asian Developing Countries**

Country	Physical Capital/Labor Ratio[a] (1983)	Educational Effort Index[b] (1983) A	Educational Effort Index[b] (1980) B	Arable Land/Labor Force (1983)	Minerals Production/ Labor Force (1980)	Product Cycle Readiness[e] (1983)	Economies of Scale[f] (1983)	Domestic Policy[g] (1981-1984)	Openness of Commercial Policy[h] (1980s)
Physical Capital-Intensive									
Japan	340	176	229	23	–[c]	160	227	188	–[c]
Australia	339	173	201	–[d]	–[c]	141	182	–[c]	–[c]
Singapore	272	128	82	2	0 (approx.)	118	101	178	238
New Zealand	233	155	201	110	–[c]	130	118	–[c]	–[c]
Hong Kong	174	130	85	2	0 (approx.)	116	93	123	–[c]
Beginning Capital-Intensive									
Taiwan	91	165	–[c]	60	0 (approx.)	167	54	158	–[c]
Korea, Rep. of	78	170	181	44	35	155	56	119	65
Malaysia	77	95	24	60	961	99	38	97	184
Labor-Intensive									
Philippines	24	124	203	124	151	122	44	88	48
Thailand	18	56	170	221	129	78	43	122	134
Indonesia	15	63	31	78	90	75	108	100	96
Sri Lanka	12	104	28	60	1	94	14	52	82

Very Labor-Intensive

Pakistan	9	27	15	244	1	59	64	64	37
India	7	57	67	193	25	75	461	115	50
Burma	4	40	34	207	7	46	24	—[c]	—[c]
Nepal	3	41	24	103	0 (approx.)	44	12	68	—[c]
Bangladesh	3	29	27	103	1	40	61	63	66

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[a] Capital stocks were roughly estimated by summing ten-year values of gross fixed investment (implicitly assuming a ten-year useful life).

[b] Index A is based on the population enrolled in secondary schools divided by the secondary school age population, which can exceed 100. Index B is based on the population enrolled in universities, colleges, and technical schools divided by the population in age group 20-24.

[c] Not included.

[d] Australia was left out because its inclusion made the other indices very low.

[e] The average of the share of industry in GNP index and the educational Index A.

[f] Population size adjusted for per capita income.

[g] Based on a simple average of the domestic saving rate, inflation rate (inverted), and ratio of government deficit to GNP (inverted).

[h] Based on frequency of non-tariff barriers and average ad valorem tariff rates.

Note: All indices have the average standing of the countries included as a base.

Sources: Asian Development Bank, *Key Indicators of Developing Member Countries of ADB* (Manila, April 1985 and October 1985); IMF, *International Financial Statistics, Yearbook 1985* (Washington, D.C., 1985); United Nations Economic and Social Commission for Asia and the Pacific, *Statistical Yearbook for Asia and the Pacific, 1984* (New York, 1985); World Bank, *Social Indicators Data Sheets* (Washington, D.C., June 1984); World Bank, *World Development Report 1985* (Washington, D.C., 1985); International Labour Organisation, *Year Book of Labour Statistics, 1983* (Geneva, 1983); Food and Agriculture Organization, *FAO Production Yearbook, 1984* (Rome, 1985); Council for Economic Planning and Development, Executive Yuan, *Taiwan Statistical Data Book 1985* (Taipei, 1985); World Bank, *Commodity Price Data* (Washington, D.C., various issues); U.S. Department of the Interior, *Minerals Yearbook*, Centennial Edition 1981 (Washington, D.C.: Government Printing Office, 1983); Dean A. DeRosa, "Trade and Protection in the Asian Developing Region", *Asian Development Review*, vol. 4, no. 1 (1986), pp. 27-62; and country sources.

exporters of agricultural goods (food and agricultural raw materials).[12] Pakistan, Thailand, Burma and India are best placed in this respect. This does not necessarily mean that they have achieved major net agricultural exports (though clearly Thailand has) but that they have the potential to do so. All countries below 110 would basically be net importers with the relative importance of imports increasing as the index falls. As with Heckscher-Ohlin goods, this does not mean that government interventions cannot reverse comparative advantage and turn a basic net importer into an exporter (or vice-versa). The emphasis on self-sufficiency apparently has accomplished this in several countries, e.g., Indonesia. Policy may lead to different outcomes than forecast, but the ranking of Ricardo land-based resources shows where the natural agricultural advantage lies.[13]

Mineral production, excluding petroleum products, and assumed to be closely related to mineral wealth, is highest in India, followed by Indonesia and Malaysia. However, on a per worker basis, Malaysia is far ahead followed by a second tier consisting of Thailand and the Philippines. Obviously, these three countries would have a comparative advantage in producing mineral raw materials and mineral-based manufactures. On a per worker basis, an adjustment to determine export potential, Indonesia is below the other three ASEAN countries. India, though largest in terms of non-oil mineral production, would tend to absorb domestically most of this large output. All the other Asian developing countries would be expected to be net importers of minerals.

Turning to product cycle commodities, the basis for the movement of knowledge-intensive goods to new production centers should be related to the ability to absorb and efficiently replicate "foot-loose" technology. Three factors seem to be involved: human resources, the degree of industrialization (the industrial infrastructure, from roads to telecommunications, should be in place), and the openness of the economy to direct foreign investment (often a necessary part of the technological transfer) and trade. The latter is important since an inward-looking country, in addition to not being ready to accept imports that may be required as inputs, will have many policies that penalize exports.

A ranking of countries in terms of readiness for product cycle goods (e.g., consumer appliances, electronics and semiconductors and sound reproducing equipment) based on a simple average of their indices for human capital and the degree of industrialization is given in Table 2. The policy framework is discussed below; a suitable direct foreign investment index across the Asian developing countries was not available. Based on the index presented, the countries most likely ready to participate directly in the product cycle process are Taiwan and the Republic of Korea. Their indices of "readiness" are ahead (Taiwan's) or in line with the index for Japan, a major initiator in the product cycle process. And, of course, in many basic and hi-tech (especially electronics) industries, they are already involved in the process.

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[12] A more detailed breakdown would segregate land by climatic zones. Except for South Asia, the land of almost all the Asian developing countries included in the table is in the tropical rainy climatic zone. In South Asia, the largest share of land is also in this category, though lands in the dry and humid mesothermal climatic zones are also important. It would also be useful to differentiate between forests (including cropped forests) and other croplands.

[13] Indonesia has taken Draconian steps to achieve food self-sufficiency, basically against its "revealed" comparative advantage.

The countries in the second tier in terms of readiness, Singapore, Philippines and Hong Kong, have already been involved in the process and so must meet the initial conditions for "hosting" product cycle technological transfers. These, as a guess, have been relatively greater in Singapore and Hong Kong. The Philippines' standing probably represents potential more than accomplishment. But this potential offers a basis for optimism under present circumstances in the country.

Malaysia and Sri Lanka could be considered the "borderline" group in this context. The others, except where government intervention helps to pave the way (probably at a high cost), are not as likely to attract foot-loose industries through the market. This does not mean that no such transfer will take place but that the required nexus of industrial experience, business support systems, and an educated labor force is not available.[14]

Other than Ricardo goods, the investigation in this analysis of the circumstances giving rise to trade have not included the factors, domestic economies of scale and pioneering specialization, that lead to comparative advantage among countries with similar factor endowments.[15] The first of these factors, potential domestic economies of scale, is proxied by an index based on the population of a country adjusted for differences in the level of development.

On this basis, India, despite very low income per capita, appears by far as the largest market *now.* There is no simple criteria for deciding on the cut-off where international markets must usually complement domestic markets to achieve economies of scale, but in terms of present size, all countries after the borderline countries, Indonesia and the Republic of Korea, appear to be dependent on international trade (and where their low incomes partially reflect their lack of success in competing internationally). Burma, Bangladesh, Pakistan, Philippines and Thailand, having a population basis for economies of scale but not yet achieving this potential, could reach the level for significant economies of scale (though Burma has a long way to go) by growth in productivity, a slow process unless international markets are tapped for this purpose.

The initial specialization leading to comparative advantage based on learning-by-doing suggests that the likely key factors are the policy environment and the size of the domestic market (a stimulus even where economies of scale are not highly important, since having a relatively safe market is important for any product, where international trade prospects are uncertain). But giving a quantitative ranking is difficult.

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[14] This conclusion may be misleading for a country of the size of India. Some Indian states, if taken as countries, might have product cycle indices much above the country average.

[15] Specialization either through innovation or, in a regional sense, in goods that have a large locational advantage because of high transportation costs or quick delivery requirement.

Similarly, it is difficult to find a reasonable proxy for the potential for intra-industry trade. This depends on specialization by countries at similar stages of development in components of the same industry. It can involve almost any kind of product — from different varieties of rice to very specialized applications of genetic engineering — but mostly occurs in the machinery and consumer goods lines. Essentially, such trade results where borders are open and where factor endowments and the degree of industrialization are similar. Since trade is highly constrained by both tariff and non-tariff barriers among most Asian developing countries, the first condition is not often met. Based on the last two and a greater than average degree of openness, intra-industry trade would be greatest between Taiwan, Republic of Korea, Hong Kong, Singapore and Malaysia (but especially the first three). On the other hand, where such trade might be expected between Pakistan and India or the remaining ASEAN countries, it would likely be ruled out by commercial policy.

The final determinant of trade patterns is the policy environment. There is no way of accurately measuring policy, but two surrogates, the first, based on domestic policies, and the second, based on commercial policy, are given in Table 2.

From a domestic policy standpoint, the ability to respond in the long run (i.e., net of debt financing) to changing comparative advantage, to gain economies of scale, and to keep competitive in world markets will vary directly with the domestic saving rate and inversely with the inflation rate and the government's propensity to intervene in the economy.[16] Table 2 gives a domestic policy index based on the simple average of these three policy indicators. The countries with the policies most likely to foster exports are the countries that have done best at exporting, though Thailand's relatively high position and the closeness of the Republic of Korea and India may come as a surprise. On the other hand, given their different and more inward-looking approach to development, it is not surprising that the other South Asian countries are at the bottom of the list.

The ranking differs somewhat for commercial policy. Based on the combined index shown, giving equal weight to ad valorem tariff rates and the frequency with which selected non-tariff barriers are applied, both compared to average values for the Asian developing countries in this analysis, the resulting index of relative openness is highest in Singapore followed by Malaysia and Thailand.[17] If data were available, Hong Kong would most likely be highest of the countries included in this analysis. The relatively least open economy is Pakistan, with the Philippines and India not much higher and considerably below the regional average. The Republic of Korea and Bangladesh, though higher, are also well below average in openness.

Generally, Singapore, Malaysia and Thailand are the countries with policies most likely to promote growth through a two-way trade. Certainly, Hong Kong, and possibly Taiwan, would be in this group if data were available. Indonesia and the Republic of Korea would be next, with a lack of openness pushing the latter down for growth through two-way trade. At the bottom would be the Philippines, Sri Lanka, Bangladesh and Pakistan.

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[16] Very roughly measured here by the ratio of the government's overall deficit to the level of GNP.

[17] "Openness" because the index is based on the reciprocal of the level of tariffs and non-tariff barriers.

Rather than try to summarize the predicted trade patterns, region by region or country by country, derived from the discussions on policy environment, relative factor endowments, Ricardo goods, the relative readiness for product cycle goods and for intra-industry trade or learning-by-doing, and the presence or absence of economies of scale, these predictions will be related to and tested against actual trade patterns in the next section. To be able to understand and perhaps predict what will happen in the future, it is necessary to first examine the nature of trade and how it has changed in the past.

Trade Structures: Evidence of Changing Comparative Advantage

The shares of total exports accounted for by different types of goods for the NICs, Other ASEAN, and South Asia — the groupings used for analytical purposes in this article — and the countries in each of these groups are given in Table 3. To "read" this table, it is first necessary to know how one-digit Standard International Trade Classification (SITC) commodity classes are combined or adjusted to define primary products, labor-intensive manufactures, resource-based manufactures,[18] physical capital-intensive manufactures, and human capital-intensive manufactures.[19] Some classes, of course, include both labor-intensive and capital-intensive goods. For the purpose at hand, reclassification seems far too tedious and, where such aggregation problems are potentially difficult (e.g., electrical machinery), they can be discussed in the text.

However, it is useful to discuss briefly the meaning of these data. They reflect the twin effects of domestic supply and foreign demand conditions. On the supply side, in addition to the emphasis on relative resource endowments and stages of development, domestic economic policies and domestic demands are also important. The commodity composition of exports will change as these determinants, both domestic and foreign, change. Thus, resource endowments and the stage of development are only two of many factors influencing a country's (or a region's) trade pattern. Where interventions are minimal and

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[18] Mostly between the labor-intensive and the physical capital-intensive categories in physical capital/labor ratios, though textiles are rapidly changing.

[19] These definitions are as follows:

Primary Products = Food (SITC 0, 1, 4, + 221) + Raw Materials (SITC 2-221) + Petroleum Products and Other Mineral Fuels (SITC 3).

Resource-Based Manufactures = Textiles (SITC 65), Metal Manufactures (SITC 69), Other Resource-Based Manufactures (SITC 6-65, 67, 69).

Human Capital-Intensive Manufactures = Electric Machinery (SITC 72), Instruments, Clocks, Watches (SITC 86), Chemicals 2 (SITC 54, 58, 59).

Labor-Intensive Manufactures = Clothing (SITC 84), Furnitures (SITC 82), Footwear(SITC 85), Miscellaneous Manufactures (SITC 81, 83, 89).

Physical Capital-Intensive Manufactures = Non-Electric Machinery (SITC 71), Transportation Equipment (SITC 73), Iron and Steel (SITC 67), Chemicals 1 (SITC 51, 52, 53, 55, 56, 57).

Table 3: **Shares of Different Commodity Classes in Total Exports by Country and Region for Asian Developing Countries, 1982 and Change, 1970-1982**
(Percentages)

Commodity Class	NICs		Other ASEAN		South Asia		Hong Kong		Rep. of Korea		Singapore		Taiwan	
	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)
Manufactured Products	80.8	10.4	17.3	2.9	56.0	8.0	96.6	0.7	91.7	14.5	41.4	13.6	89.0	12.4
Primary Products	16.8	-11.8	79.5	-5.1	43.5	-8.3	2.8	-1.1	8.1	-14.4	50.1	-19.2	11.0	-12.1
Labor-Intensive Manufactures	30.2	-6.9	3.5	2.9	11.2	7.4	58.3	-8.2	29.1	-13.1	5.6	1.1	37.1	9.4
Textiles	6.6	-2.8	1.3	0.8	20.6	-5.1	6.1	-4.5	10.2	0.0	1.7	-1.8	8.0	-5.8
Other Resource-Based Commodities	8.4	0.8	5.9	-5.9	13.7	5.1	3.8	-0.2	11.4	-2.9	5.3	0.7	11.2	-0.9
Total	15.0	-8.9	7.2	-2.2	45.5	7.4	68.2	-12.9	50.7	-15.9	12.6	0.0	56.3	2.7
Physical Capital-Intensive	17.3	11.4	1.2	0.1	7.1	-0.6	4.3	2.1	27.8	23.4	19.0	9.9	13.4	4.8
Human Capital-Intensive	15.1	7.8	5.4	4.9	3.4	1.2	24.0	11.3	13.2	6.9	18.6	12.5	19.3	4.9
Total	32.4	19.2	6.6	5.0	10.5	0.6	28.3	13.4	41.0	30.3	37.6	22.4	32.7	9.7
(of which elec. mach.)	(13.2	4.7)	4.7	4.6	1.2	0.4	(10.5	8.3)	(10.0	4.7)	(4.0	1.4)	(15.0	2.6)

(continued)

Table 3: **Shares of Different Commodity Classes in Total Exports by Country and Region for Asian Developing Countries, 1982 and Change, 1970-1982**
(Percentages)

Commodity Class	Indonesia		Malaysia		Philippines		Thailand		Bangladesh		Sri Lanka		India		Pakistan	
	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)	1982 (Share)	1970-1982 (Change)
Manufactured Products	5.4	3.8	28.3	2.2	24.5	16.9	31.7	15.6	61.6	-	26.1	24.7	58.9	6.4	57.9	0.7
Primary Products	94.4	-3.8	71.5	-1.6	49.3	-43.0	67.0	-13.6	37.8	-	73.9	-24.7	40.9	-6.3	40.7	-2.0
Labor-Intensive Manufactures	0.6	0.6	2.4	1.6	11.8	11.0	8.6	8.2	1.9	-	17.5	17.0	11.8	5.5	9.2	5.5
Textiles	0.2	-	1.1	0.7	1.1	0.6	5.1	3.9	45.6	-	0.5	0.5	15.2	-6.6	39.5	-6.6
Other Resource-Based Commodities	3.4	2.6	8.1	-14.2	5.1	0.5	11.1	-2.6	9.3	-	5.2	4.7	17.7	0.2	5.6	0.2
Total	4.2	3.2	11.6	-11.9	18.0	12.1	16.2	9.5	54.9	-	23.2	22.2	44.7	-0.9	54.3	-0.9
Physical Capital-Intensive	0.5	0.3	2.4	0.5	1.8	0.6	1.1	0.7	3.6	-	2.2	2.0	9.7	-1.5	2.0	1.3
Human Capital-Intensive	0.6	0.3	14.2	13.5	6.6	4.2	5.7	5.3	1.1	-	0.6	0.4	4.6	1.7	1.6	0.3
Total	1.1	0.6	16.6	14.0	8.4	4.8	6.8	6.0	4.7	-	2.8	2.4	14.3	0.2	3.6	1.6
(of which elec. mach.)	(0.5	0.5)	13.2	(12.9)	(2.4	2.4)	(4.7	4.6)	0.2	-	-	0.2	1.8	-	0.2	-

Sources: United Nations, Computer Tapes (1970, 1980 and 1982); Inspectorate General of Customs, *The Trade of China*, Chinese Maritime Customs Statistical Series, no. 1 (Taipei, 1982); United Nations, *Commodity Trade Statistics 1970, China (Taiwan)*, Statistical Papers, Series D, vol. xx, no. 1-10 (New York, 1971).

competitive markets are at work, a country's (or region's) underlying comparative advantage, based at any time on resource endowments and stages of development, will largely determine the outcome. Deviations from this basic pattern are evidence of distortions in trade and suggest, very roughly, the implications of liberalization and of "getting the prices right" for trade.

Turning to the country groupings, there has been a continued shift in the exports of the NICs from primary to manufactured commodities.[20] By 1982, 81 per cent of the exports of the NICs were in the manufacturing category. Although labor-intensive manufactures retain the largest share, their share is falling, while both physical and human capital-intensive exports increased sharply. These developments reflect the generally favorable policy environment in the NICs, the continued process of capital accumulation (both physical and human) per worker, the movement of product cycle goods – especially in the electrical machinery category – to the NICs, and the scale economies achieved (partly due to policy) through international specialization.

The Republic of Korea most closely fits the general NIC picture, with a very large increase in the share of physical capital-intensive exports in total exports, a smaller but still significant increase in the share of human capital-intensive exports, almost no change in resource-based exports, and a substantial drop in labor-intensive exports. By 1982, the Republic of Korea's physical capital-intensive exports were approximately equal to the share of labor-intensive exports.

Each of the other NICs differs somewhat from the overall pattern. Hong Kong has a much higher share of labor-intensive exports (58 per cent) and a much lower share of and growth in physical capital-intensive exports, a difference probably accounted for by Hong Kong's laissez-faire approach compared with the Republic of Korea's subsidization of heavy industry. Hong Kong and Singapore have a relatively high and rapidly growing share of human capital-intensive exports, reflecting their special factor endowments. Singapore, because of its quasi-entrepôt trade, has a much smaller share of manufactured exports (only 41 per cent) and a much lower, but slightly increasing, share of labor-intensive exports. Taiwan has a much above the NIC average share of labor-intensive exports, and this share has been increasing compared with the shares of the other NICs. Taiwan and Hong Kong are similar in terms of their manufactured export structure but differ in the ways noted from the other NICs. The future of each will be conditioned by these similarities and differences.

The Other ASEAN countries, having much greater natural resource endowments and starting from a much lower capital/labor base, are at the other extreme, exporting mostly primary products and, within their relatively small manufactured export share, exporting increasing relative amounts of labor and human capital-intensive commodities. These patterns, including the increase in labor-based manufactured exports, are as would be expected, given factor endowments and the capital/labor starting point. In the future, if barriers remain the same, one would expect to find the Other ASEAN countries increasingly exporting labor-intensive goods and the labor-intensive components of electrical machinery to the NICs and the developed countries while exporting resource-based manufactures to all countries and more and more physical capital-intensive commodities to South Asia and the other developing countries. These trends would be increased if trade barriers, especially among the developing countries, are reduced.

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[20] To some extent, this reflects the change in the relative prices of primary and manufactured products.

Thailand and Malaysia are most like the Other ASEAN aggregate, with Thailand showing a particularly large shift from primary to manufactured exports from 1970 to 1982. Malaysia, in contrast, shows almost no change. This, however, masks a large decrease in other resource-based manufactured exports (tin, for example) and a large increase in the labor-intensive (mostly semiconductors) component of electrical machinery. The increase in Thailand's manufactured exports was in labor-intensive manufactures, textiles, and the labor-intensive part of electrical machinery, a "textbook" result of market-led industrialization and reflecting Thailand's high "policy index" standing.

The Philippines' share of manufactured exports grew at a slightly faster pace than Thailand's (by 17 per cent compared with 16 per cent), but in 1982 remained below both Thailand and Malaysia. The huge decrease in the share of primary product exports resulted from the shift to manufactured exports and an even larger shift to "special transactions", indicative of the past policy problems of the Philippines. The increase in the share of manufactured exports, which could have been much larger if not penalized by the numerous controls and general import substitution policies, was, as in Thailand, concentrated in labor-intensive goods and the labor-intensive part of electrical machinery exports.

Indonesia is a separate case. The share of manufactured exports, though increasing, remained very low; the country's exports were dominated by petroleum products. And the small increase that occurred was not in the expected labor-intensive sectors but in other resource-based exports (e.g., wood products, tin, copper and aluminum). The natural advantages for labor-intensive exports were cut off by the exchange rate effects of booming oil prices and by the relatively strong protectionist (and import substitution) policies followed.

South Asia is between the other two groups, with shares in exports of primary and manufactured products at relatively similar levels. However, as in the other country groups, the share of manufactured exports increased and of primary products fell. The growth in manufacturing exports was concentrated in labor-intensive exports as expected and in other resource-based exports. The product cycle electrical machinery export base had yet to develop in South Asia. In structure, unlike the other groups, South Asian manufactured exports are dominated by textiles and other resource-based exports, four times human capital-intensive or physical capital-intensive exports. It is not surprising that the share of the latter is greater than for Other ASEAN, considering the economies of scale possible in the large and protected Indian market and the policies India has followed to promote heavy industry.

The shares of manufacturing and primary products in exports for India and Pakistan are rather similar to the regional average. Bangladesh is also close to the average, reflecting similar policies and, perhaps, development experience. Sri Lanka's shares, on the other hand, are rather similar to the Other ASEAN countries, with a 74 per cent share for primary products.

The growth in manufactured exports in India came largely from labor-intensive exports. In terms of structure, as guided by the planners and not the market, the distribution of manufactured exports between the categories shown is more even than for any of the other countries. This means, compared with a priori predictions, a larger than expected share of physical capital-intensive and textile exports and a lower than expected share for labor-intensive exports. With more open development, one would expect some relatively wide shifts in the composition of India's exports.

The share of manufactured exports in Pakistan, dominated by textiles (40 per cent) *and* on the labor-intensive side, floor coverings, for example, changed very little from 1970 to 1982. There was one significant internal shift, from textiles to labor-intensive exports. The emphasis on textiles, where market-sharing agreements and rapid technological change can make the future uncertain, places pressure on Pakistan to develop its labor-intensive advantage in other ways. Bangladesh is even more dependent on textiles and under even more pressure to expand its labor-intensive exports (now *only* 1.9 per cent in a country with one of the world's highest labor/land and labor/capital ratios). In both countries, more emphasis on market-led export growth is required.

Sri Lanka has achieved the largest increase in the share of manufactured exports. This has come about partly because of adverse changes in commodity prices, but mostly from policy reforms that stimulated the relative growth of labor-intensive exports and other resource-based exports. Under present circumstances, these trends have probably not continued, but the possibilities are clear.

Geographic Composition of Exports of Asian Developing Countries

Industrial Countries, Other Destinations, and Comparative Advantage. Having established the relatively close correspondence of the commodity structure and changes in the commodity structure of trade of Asian developing countries with the structure expected on the basis of resource endowments and stages of development, the geographic composition of trade by commodity class may now be examined. Table 4 helps to trace developments in intra-regional trade and trade between country groups and the industrial countries. It is also possible to trace trade developments between the country groups and the other developing countries and the rest of the world (ROW), consisting mostly of "centrally planned economies". The pattern of trade between the country groups and different destinations across commodity classes and a comparison of the experiences of the groups indicate two related results. First, it is possible to see whether the trade pattern by commodity class to the various destinations roughly conforms with the pattern expected on the basis of comparative resource endowments and stages of development. Second, using this information, it may be possible to suggest where greater trade liberalization might allow increased trade along the lines of *expected* comparative advantage.

However, it may be useful to first review some of the determinants of the shares of different destinations in a region's exports of a particular commodity. These include the relative size of the market, and in terms of changes in shares, the relative growth rate in different destinations, the relative resource endowments of the exporting and importing regions, political factors, and all the determinants, other than relative resource endowments, that affect the relative delivered prices of a country's exports in each importing market. A partial list of the latter would include trade barriers, sectoral and industrial competition policies, tax, subsidy, exchange rate and macroeconomic policies, and differences in geographic proximity, infrastructure for exporting, and tastes.

Clearly, it is virtually impossible to measure precisely the significance of any one determinant from such a large number. However, given all the possibilities for distortions, if the pattern across commodities follows the lines expected on the basis of comparative advantage, then it can be assumed with some confidence that trade in the future will evolve along the same lines. If distortions become large enough to open profitable opportunities for smuggling or illegal production, these activities will tend to constrain trade within the rough lines of comparative advantage. With some time lag, the cost of the distortion will become prohibitive.

The data in Table 4 show that the shares of NIC, Other ASEAN, and South Asian exports to the industrial countries generally vary between commodity classes as would be expected on the basis of relative resource endowments and stages of development. This is more so for the NICs and Other ASEAN group than for South Asia. And, for the NICs and Other ASEAN, by inference, since the ROW does not represent a significant share, the same conclusion holds for exports by commodity class to the developing countries.

For the NIC, Other ASEAN and South Asia groups, in conformity with expectations, the share of the industrial countries is highest at over 70 per cent for labor-intensive exports. For the NICs and Other ASEAN countries, this is followed by the relatively labor-intensive component of human capital-intensive exports, the semiconductor subcategory of the electrical machinery subsector, sent mostly to the United States.[21] The factors that turned first the NICs and then the Other ASEAN countries into major exporters of human capital-intensive goods to the industrial countries have not yet taken hold in South Asia.

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[21] Recently, the NIC share in this category has been shifting toward the more physical capital and human capital-intensive production and export of consumer electronics. The concentration on one product, semiconductors, for one market, the United States, leaves the human capital-intensive exports of the Other ASEAN group in a classic "eggs-in-one-basket" situation.

Table 4: **Shares of Industrial Countries, Asian Developing Countries and Other Regions in NIC, Other ASEAN and South Asian Exports by Commodity Class, 1982 and Change, 1970-1982**
(Percentages)

Direction of Exports	**Percentage Share, 1982**						**Change in Percentage Share, 1970-1982**					
	Primary Products	**Labor-Intensive**	**Resource-Based**	**Physical Capital-Intensive**	**Human Capital-Intensive**	**Total**	**Primary Products**	**Labor-Intensive**	**Resource-Based**	**Physical Capital-Intensive**	**Human Capital-Intensive**	**Total**
NIC to IC	39	80	43	52	65	59	-19	-8	-15	+ 21	-7	-10
OA to IC	65	77	62	46	67	65	-2	+ 23	-22	+ 27	+ 35	-3
SA to IC	39	72	55	15	30	46	-17	+ 22	-6	-18	+ 3	-5
NIC to ADGC	41	3	28	23	20	22	+ 31	0	+ 9	-4	+ 8	+ 11
OA to ADGC	26	10	29	45	31	26	+ 3	-16	+ 21	-17	-18	+ 4
SA to ADGC	12	1	9	25	12	11	+ 6	-4	+ 1	+ 14	-3	+ 4
NIC to ODGC	16	16	27	24	14	19	-10	+ 7	+ 4	-17	-2	0
OA to ODGC	6	12	6	9	1	6	0	+ 3	+ 1	-10	-17	0
SA to ODGC	29	13	23	44	30	26	+ 13	-5	-3	-1	-19	+ 3

NIC to ROW	4	1	2	1	1	2	-2	+1	+2	+1	+1	0
OA to ROW	3	1	2	0	0	3	0	+1	0	0	0	0
SA to ROW	20	13	14	15	28	17	-2	-14	-3	+3	+19	-2
NIC to NIC	15	2	15	6	10	9	+9	0	+1	-5	0	+2
OA to NIC	21	9	24	31	28	21	+1	-17	+19	-12	-9	+2
SA to NIC	5	1	6	5	2	5	+2	-3	0	+2	-4	+1
NIC to OA	20	1	9	13	9	9	+17	0	+5	-2	+7	+6
OA to OA	4	1	3	11	3	3	+1	-9	+1	-5	-9	+1
SA to OA	2	0	1	9	3	2	+1	-1	0	+5	-2	+1
NIC to SA	6	0	4	4	1	3	+5	0	+3	+3	+1	+2
OA to SA	1	0	2	3	0	1	+1	0	+1	+1	0	+1
SA to SA	5	0	2	11	7	4	+3	0	+1	+7	+3	+2

Notes: NIC = Newly Industrializing Countries; IC = Industrial countries; OA = Other ASEAN countries; SA = South Asian countries; ADGC = Asian developing countries; ODGC = Other developing countries; and ROW = Rest of the world.

Sources: United Nations, Computer Tapes (1970, 1980 and 1982); Inspectorate General of Customs, *The Trade of China*, Chinese Maritime Customs Statistical Series, no. 1 (Taipei, 1982); United Nations, *Commodity Trade Statistics 1970, China (Taiwan)*, Statistical Papers, Series D, vol. xx, no. 1-10 (New York, 1971).

As would be expected, based on the endowments of Ricardo goods *and* the stage of development, the share of the industrial countries in primary product exports is greatest for the Other ASEAN group. This holds especially for raw materials and petroleum products within the primary products categories (see Table 5).[22] In foods, because of industrial country policies blocking off primary food imports and the advantage of the NICs in food processing, the NICs export a relative larger share than the Other ASEAN countries to the industrial countries. The industrial country share in South Asian primary product exports, because of the significant portion going to the ROW, is lower than the Other ASEAN group (and by category, except for raw materials, lower than the NICs). Unless the role of the ROW is recognized, this outcome is unexpected, especially since the industrial country share in South Asia's exports of closely related resource-based manufactures is above average and close to that of the Other ASEAN group. The relatively high industrial country shares of these exports for the Other ASEAN and South Asia groups are expected.

Seemingly following closely the stage of development of the exporting country and the related physical capital-intensity ratio, industrial country shares in physical capital-intensive exports are highest for the NICs, followed unexpectedly closely by the Other ASEAN group with South Asia far behind. This result holds for all four subcategories, with the industrial share reaching 20 per cent for South Asia only in basic chemicals.

It bears emphasizing that South Asia's exports are much more dependent than those of the other Asian developing countries on developing countries outside Asia and the ROW. Non-Asian developing countries are the largest markets for South Asian exports of primary products and physical and human capital-intensive manufactures. There is, with the ROW also involved, a different variation across commodity classes, especially in the capital-intensive sectors, than for the other country groups. However, in broad terms, the direction of trade follows, though less closely than in other regions, the lines expected on the basis of relative resource endowments and stages of development. Still, it is worth noting that South Asia is overly dependent, in relation at least to the other country groups, on the two least stable and, in terms of imports, least rapidly growing destinations.

The changes from 1970 to 1982 in industrial country shares by commodity classes for the country groups are generally as expected, given the continuing growth in both physical and human capital per unit of labor, the increasingly sophisticated infrastructure in place, and the lessons learned from the competitive process, especially by the NICs and Other ASEAN countries. However, it is important to note the very low proportion of total trade sometimes accounted for by particular commodity classes, especially manufactured exports in Other ASEAN countries. Large percentage changes can result from very small absolute changes in such circumstances. The share of a particular commodity class in the total trade of each country group (see Table 3) should be kept in mind in interpreting the changes in shares in Tables 4 and 5.

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[22] Disaggregations of the geographic composition of exports based on SITC categories are given in Table 5.

In regard to changes in shares across commodity classes to the industrial countries, it should be noted that since the industrial countries as a group grew less rapidly than the developing countries (almost entirely because of the performance of the Asian developing countries) and since the ROW shares are small except for South Asia, it would be expected that the relative growth effect, taken alone, would reduce the industrial country share in each commodity class. Although it would have some impact, the relative growth effect should not greatly affect the relative change in industrial country shares across commodity classes. Variations in these shares can be largely attributed to other factors.

In several instances, the industrial country share of Asian developing country regional exports increased and changes across commodity classes varied widely, suggesting that there were some major shifts either in comparative advantage or in the other sources (e.g., trade barriers) of change in such shares. However, it is possible to explain most of the changes in terms of what would be expected with economic development and markets playing a varying but ultimately dominant role in determining trade flows. Thus, the decrease in the industrial country share of NIC labor-intensive exports and the increase in this share in the Other ASEAN and South Asian country groups accord with what would be expected as NICs move upmarket and Other ASEAN and South Asian countries become increasingly industrialized. This suggests that the latter two are partially filling a gap left by the NICs. The large increase in the industrial country share of physical capital-intensive exports of the NICs is also expected for the same reason, though the even larger increase in the industrial country share in Other ASEAN physical capital is less expected and impressive. The decline in the share of such exports from South Asia with a simultaneous increase in the Asian developing country share seems more in line with the relative growth effect without any change in comparative advantage.

The changes in the human capital-intensive shares of industrial countries by Asian developing country groups tend to reflect the changes in labor-intensive exports, though the size of the increase in the share of such exports from the Other ASEAN group to the industrial countries is notable.

All the groups show no change or a decline in the share of primary product and resource-based exports to the industrial countries. These products also account for a declining share of total trade, the outcome of falling relative prices of commodities and their generally price inelastic demand. The slower growth in the industrial countries thus explains the further decline in the industrial country share of these exports (the relative growth effect explains why they increased to the Asian developing countries).

In sum, these developments are promising for further growth in trade along the lines of evolving comparative advantage. There have been many shifts in relative shares between commodity classes. This is especially so for the Other ASEAN group where the relative shares to industrial countries (and so

Table 5: **Breakdown by Major Subcategories of Shares of Industrial Countries, Asian Developing Countries and Other Regions in NIC, Other ASEAN and South Asian Exports by Commodity Class, 1982 and Change, 1970-1982**
(Percentages)

Direction of Exports and Change	Food	Raw Materials	Petro Products	Clothing	Furniture	Footwear	Misc. Manuf.	Textiles	Metal Manuf.	Other Resource-Based
1982										
NIC to IC	55	47	26	83	78	85	74	34	51	47
OA to IC	53	63	70	78	87	68	75	52	30	65
SA to IC	37	50	4	75	29	83	63	49	40	67
1970-1982										
NIC to IC	-8	-17	-15	-7	+2	-2	-13	-16	-2	-26
OA to IC	-19	0	+2	-2	+23	+10	+33	+6	+10	-22
SA to IC	-15	-12	-25	+38	+22	+41	-2	-1	+16	+18
1982										
NIC to ADGC	21	26	58	1	4	1	8	35	19	24
OA to ADGC	24	28	25	7	9	8	19	33	59	28
SA to ADGC	9	16	25	1	13	0	4	9	11	8
1970-1982										
NIC to ADGC	+12	+16	+49	0	+1	0	+4	+8	+6	+14
OA to ADGC	+2	+5	-3	-10	-17	-5	-31	-8	-9	+23
SA to ADGC	+3	+11	+10	-1	+9	0	-5	+2	0	-1
1982										
NIC to ODGC	22	16	12	15	16	13	17	27	28	28
OA to ODGC	13	3	4	14	4	23	5	9	12	5
SA to ODGC	35	9	70	8	59	13	26	28	46	9
1970-1982										
NIC to ODGC	-6	+2	-18	+6	-5	+1	+9	+3	-8	+11
OA to ODGC	+7	-4	0	+11	-15	-6	-2	+1	-11	0
SA to ODGC	+14	+2	+26	-3	-30	-2	-3	+1	-3	-11
1982										
NIC to ROW	3	8	4	1	0	0	2	3	1	2
OA to ROW	9	5	0	1	0	0	0	1	0	3
SA to ROW	20	25	1	16	0	4	7	15	3	15
1970-1982										
NIC to ROW	+3	-7	+2	+1	0	0	+2	+3	+1	+2
OA to ROW	+9	-1	0	+1	0	0	0	+1	0	+1
SA to ROW	0	0	-1	-33	0	-38	+4	-1	-12	-7
1982										
NIC to NIC	8	13	20	1	3	1	4	23	5	11
OA to NIC	14	25	22	6	9	8	16	24	37	24
SA to NIC	3	9	14	1	10	0	2	6	3	6
1970-1982										
NIC to NIC	+2	+7	+13	0	+1	+1	+1	+2	-1	+4
OA to NIC	-4	+2	+6	-1	-14	-1	-23	-6	-15	+21
SA to NIC	+2	+5	0	-1	+9	0	-5	+1	0	-1
1982										
NIC to OA	11	12	29	0	1	0	3	8	11	9
OA to OA	6	2	3	1	0	0	2	5	19	2
SA to OA	1	2	4	0	2	0	1	1	5	0
1970-1982										
NIC to OA	+9	+11	+28	0	0	-1	+2	+3	+5	+6
OA to OA	+3	+2	-9	-9	-3	-4	-9	-6	+4	+1
SA to OA	0	+2	+4	0	-1	0	0	0	-2	-1
1982										
NIC to SA	2	4	9	0	0	0	1	4	3	4
OA to SA	4	1	0	0	0	0	1	4	3	2
SA to SA	5	5	7	0	1	0	1	2	3	2
1970-1982										
NIC to SA	+1	+3	+8	0	0	0	+1	+3	+2	+4
OA to SA	+3	+1	0	0	0	0	+1	+4	+2	+1
SA to SA	+1	+4	+6	0	+1	0	0	+1	+2	+1

(continued)

Table 5: **Breakdown by Major Subcategories of Shares of Industrial Countries, Asian Developing Countries and Other Regions in NIC, Other ASEAN and South Asian Exports by Commodity Class, 1982 and Change, 1970-1982**
(Percentages)

Direction of Exports and Change	Non-Elec. Machinery	Transport Equipment	Iron & Steel	Chemical 1	Electrical Machinery	Instruments, Clocks, Watches	Chemical 2
1982							
NIC to IC	53	52	43	63	70	65	36
OA to IC	38	69	37	31	68	63	57
SA to IC	18	8	15	21	17	48	33
1970-1982							
NIC to IC	+16	+16	+23	+39	-11	+7	+24
OA to IC	+36	+66	+2	+3	+66	+5	+19
SA to IC	-4	+5	-29	-10	0	-1	+8
1982							
NIC to ADGC	30	14	32	21	17	17	47
OA to ADGC	49	29	51	60	30	27	38
SA to ADGC	31	32	22	11	15	7	13
1970-1982							
NIC to ADGC	+11	-8	-17	+1	+8	+2	+10
OA to ADGC	-37	-66	+23	-3	-19	-7	-13
SA to ADGC	+15	+6	+15	+4	+3	-5	-5
1982							
NIC to ODGC	15	33	24	12	12	16	15
OA to ODGC	23	2	11	9	1	9	4
SA to ODGC	45	54	56	24	43	28	20
1970-1982							
NIC to ODGC	-28	-7	-7	-44	+2	-17	-35
OA to ODGC	+11	-7	-26	0	-46	+2	-6
SA to ODGC	-15	-15	+21	-14	-21	-2	-26
1982							
NIC to ROW	1	0	1	4	1	2	1
OA to ROW	0	0	0	0	0	0	1
SA to ROW	6	7	7	44	25	17	34
1970-1982							
NIC to ROW	+1	0	0	+4	+1	+2	+1
OA to ROW	0	0	0	0	0	0	+1
SA to ROW	+5	+5	-8	+19	+18	+9	+22
1982							
NIC to NIC	6	5	9	8	9	11	12
OA to NIC	33	23	30	41	28	25	25
SA to NIC	9	4	4	3	2	3	2
1970-1982							
NIC to NIC	-1	-1	-13	-2	+1	-2	-5
OA to NIC	-29	-51	+17	-1	-5	-3	-14
SA to NIC	+6	-3	+2	-2	-3	-2	-5
1982							
NIC to OA	21	6	16	12	7	5	28
OA to OA	14	4	3	18	2	1	9
SA to OA	11	13	1	4	5	3	3
1970-1982							
NIC to OA	+10	-7	-10	+3	+6	+3	+10
OA to OA	-10	-5	-9	-1	-13	-5	-3
SA to OA	+4	+7	-2	+2	+1	-2	-4
1982							
NIC to SA	3	3	7	1	1	1	7
OA to SA	2	2	18	1	0	1	4
SA to SA	11	15	17	4	8	1	8
1970-1982							
NIC to SA	+2	0	+6	0	+1	+1	+5
OA to SA	+2	0	+15	-1	-1	+1	+4
SA to SA	+5	+2	+15	+4	+5	-1	+4

Notes: NIC = Newly Industrializing Countries; IC = Industrial countries; OA = Other ASEAN countries; SA = South Asian countries; ADGC = Asian developing countries; ODGC = Other developing countries; and ROW = Rest of the world.

developing countries) have shifted especially widely in a short span of time. This reflects a rapidly changing industrial and economic structure and augurs well for the future. Especially noteworthy are the increased shares of physical, human, *and* labor-intensive manufactures to the industrial countries, large enough to raise the share of manufacturing in total trade despite a large decrease in the share of the largest manufacturing export sector, resource-based manufactures.

This analysis demonstrates that trade in general conforms with and changes with comparative advantage.[23] It seems clear that relative income growth or changes in domestic or trade policies have been less significant (unless they complemented comparative advantage) than changes in resource endowments and levels of development in explaining Asian developing country regional trade performance across commodity classes. This was evident in the structure of total exports and the structure of exports by destination. In essence, in the context of this article, this result gives confidence in the possibilities for future growth in trade, including trade between Asian developing countries, along the lines of evolving comparative advantage.

Trade between Asian Developing Countries. Although there are more deviations from expected relations in trade between the Asian developing country groups[24] than in trade between these groups and the industrial countries, the basic conclusion still follows for the basis of intra-Asian developing country trade.

Table 4 indicates that the pattern of trade by the NICs, Other ASEAN and South Asia groups with the Asian region as a whole, measured by the Asian developing country share in exports in different commodity classes, is mostly as expected. The Asian developing country share of labor-intensive exports is lowest in each country group and, for the NICs and Other ASEAN group, this share is expectedly high for resource-based and human and physical capital exports (higher than 20 per cent). In fact, there is a general similarity in the variation across commodity classes in Asian developing country shares for the Other ASEAN group and the NICs, suggesting an increasing similarity of economic structure.[25] Exceptions are the very high share in NIC primary product exports (directly a result of Singapore's refinery activity) and the even higher share of Other ASEAN physical capital-intensive exports to the Asian developing countries. This reflects the relative stages of development as the NICs increase sales of physical capital goods to the industrial countries more rapidly than before and Other ASEAN countries move into the Asian developing country market.

In addition to being lower in all commodity classes than the other two country groups, South Asia's exports to the Asian developing countries as a share of total South Asian exports unexpectedly peak for physical capital-intensive exports. Certainly, South Asia's physical capital/labor ratios would not suggest this outcome. Instead, where a critical mass was possible because of market size (India and Pakistan), investment in highly capital-intensive production facilities – far above national average capital intensities – in response to an economic plan and not market signals was carried out. They can now compete internationally, but all the policies necessary to make this so have penalized South Asia's exports in those lines where a comparative advantage might be expected. It would seem that without trade barriers elsewhere in the region and without these policies, the Asian developing country share of South Asia's labor-intensive exports would be much higher, especially the NIC share.

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[23] In an earlier analysis, the emphasis was on the distribution across destinations, comparing shares for different destinations and changes in the shares. Since the shares are dependent on relative market sizes and the changes on relative growth rates, the impact of relative resource endowments was more difficult to isolate than in the approach now used. To the extent this effect could be isolated, the results confirmed the controlling importance of comparative advantage.

[24] And between the Asian developing country groups and other developing countries (or ROW).

[25] Confirmed by the much less similar 1970 variation.

In terms of level, the Asian developing countries are clearly an important market for the NICs and Other ASEAN countries. Excluding the labor-intensive category, the Asian developing country share by Heckscher-Ohlin categories in the exports of the NICs and Other ASEAN group exceeds 20 per cent. In total exports, this share in both the NICs and Other ASEAN group exceeds 20 per cent (in South Asia it is 11 per cent).[26] These figures mean that the interdependence, at least between two of the three Asian developing country groups, is already quite high, with considerable opportunity for further growth. Trade and macroeconomic policies in one of these two groups will have a more than marginal impact on the other. South Asia, on the other hand, is much less integrated in regional markets. Unlike the NICs and the Other ASEAN group, trade with other developing countries and the ROW is more important in all five Heckscher-Ohlin commodity classes than is trade with Asian developing countries.

The changes in aggregate Asian developing country shares in the exports of the country groups between 1970 and 1982 indicate interesting developments. First, the aggregate share in primary products and resource-based exports increased in all country groups, but especially in primary products for the NICs and resource-based exports for Other ASEAN countries. These changes reflect the impact of the oil shocks and the relatively more rapid economic growth of Asian developing countries.[27] The latter should, of course, have increased the Asian developing country share in all commodity classes. However, for labor, physical capital, and human capital-intensive exports, this share increased in only two of nine possible instances. Other factors obviously were involved.

The NICs show the most positive growth in relative exports to the Asian developing countries, an important trend, although on a priori grounds it might have been expected that the Asian developing country share of NIC physical capital-intensive exports would increase as the NICs begin to out-compete the industrial countries in the rapidly growing Asian markets. Further, as the other Asian developing country groups develop their own labor-intensive industries, their share of NIC labor-intensive exports might have been expected to fall. The lack of these outcomes, especially the former, involves a possible deviation from trade based on changing comparative advantage. The NIC increase in the relative share of human capital-intensive exports to Asian developing countries is more in line with expectations, as the NICs move from semiconductors to consumer electronics.

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[26] In less aggregative terms, excluding the four labor-intensive subcategories, the share of Other ASEAN exports was greater than 15 per cent in 13 subcategories, it was greater in 12 subcategories for the NICs, but exceeded 15 per cent for South Asia in only six subcategories.

[27] The growth in petroleum exports also reflects the less rapid substitution of other energy sources for oil in Asian developing countries than in industrial countries.

Unlike the NICs, the Other ASEAN group has mostly negative changes (though a positive total change). Some can be explained by the move into industrial country markets (human and physical capital-intensive and labor-intensive), but it is surprising that the shifts are so large given the relative growth effect. This is especially so for labor-intensive exports where the Other ASEAN group might have been expected to have a significantly increasing NIC market and for physical capital-intensive exports where the Other ASEAN countries would not seem to have reached, in 1982, the necessary national capital/labor ratio.

More like the NICs, the Asian developing country share of South Asia's exports was mostly increasing, being positive in all except in labor-intensive and human capital-intensive exports. But these are the sectors where consideration of relative resource endowments would suggest that South Asia has a comparative advantage vis-à-vis the other country groups. As discussed earlier, the physical capital-intensive sector, where the Asian developing country share of South Asia's exports increased most, would not be an expected comparative advantage sector. Trade policies in the other country groups and domestic and trade policies in South Asia explain this unexpected result.

More insight into intra-Asian developing country trade can be derived from the shares of the country groups in each other's exports by commodity class. Except for labor-intensive exports, which are low among the Asian developing countries,[28] the NICs take a relatively high share of Other ASEAN exports, accounting for over 20 per cent of these exports in all the other commodity classes and in total. Thus, the NICs are an important market for the Other ASEAN countries, even if part of this is entrepôt trade through Singapore. The share of NICs in NIC exports is also relatively large for primary products, resource-based manufactures, and human capital-intensive exports.[29] Their share of South Asia's exports is considerably lower than their share of either NIC or Other ASEAN group's exports. Primary products and resource-based manufactures (textiles, rugs) are the major export categories. However, there would seem to be a much lower NIC share in both Other ASEAN and South Asian labor-intensive exports than would be expected as the NICs move upmarket.

The Other ASEAN group is an important destination for the NICs in primary products and physical capital-intensive exports, where "important" is defined as larger than a 10 per cent share. On this criterion, Other ASEAN is a major market for its own exports only in physical capital-intensive exports (which are low absolutely) and in no category is Other ASEAN a major market for South Asia's exports. In fact, given the many years that ASEAN has existed, the intra-Other ASEAN trade shares are clearly disappointing.

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[28] Though the NICs, in all but furniture, are a better market than Japan for all categories of Other ASEAN labor-intensive exports and three of four categories of South Asian labor-intensive exports.

[29] The resource-based exports of NICs to NICs are partly biased upward by the mentioned entrepôt trade.

South Asia is, on the criterion just noted, an important market for its own exports of physical capital-intensive goods. South Asia's share of Other ASEAN exports, across categories, is low and could be expanded with more open trade.

The change in trade shares between 1970 and 1982 indicate several developments. First, the NIC share of Other ASEAN labor-intensive exports decreased sharply. Since the NICs were substituting more capital using exports for labor-intensive, it might be expected that they would be shifting domestic resources from labor-intensive to physical and human capital-intensive production, opening the possibility of increasing the share of Other ASEAN exports of this type in NIC markets. Apparently, this has not happened, possibly because the NICs also have a structural adjustment problem in phasing out *their* labor-intensive production. Except for the effect of the oil shocks and NIC growth on intra-NIC trade in primary products, all the other major changes in NIC shares also involve the Other ASEAN group. The relatively large fall in the NIC share of Other ASEAN's physical capital-intensive exports and the even larger increase in the NIC share of Other ASEAN resource-based exports follow the expected adjustment paths.

Other ASEAN shares of NIC trade generally increased, making the growth in interdependence two-way. However, with the NICs becoming more competitive, it is, as already noted, surprising that the share of the Other ASEAN group in NIC exports of physical capital-intensive exports fell; perhaps a measure of the importance of distribution systems, of quid pro quo, and of geopolitics. On the other hand, Other ASEAN shares of its own exports mostly fell, with a relatively large fall in the share of labor-intensive and human capital-intensive exports. Without intervention to remove barriers, this is an expected outcome. Except for a noteworthy increase in the Other ASEAN share of South Asia's physical capital-intensive exports, the Other ASEAN share of South Asia's exports showed little or no change in either direction away from the beginning low levels of intra-regional trade.

As a market, South Asia's share of NIC exports experienced small across-the-board increases in four sectors and no change in the other. The same was true for South Asia's share of South Asia's exports, with physical capital-intensive exports most important. South Asia's share of Other ASEAN exports also generally increased though to such low levels that trade from Other ASEAN to South Asia remained miniscule. The increased role of South Asia in regional markets is a noteworthy trend. The growth so far achieved could be considerably enhanced with some easing of barriers.

In sum, exports of the Asian developing countries tend to follow and change along the lines of comparative advantage suggested by their relative resource endowments and indices of other determinants of trade discussed earlier. The structure of total exports across commodity classes and of exports to industrial countries, to Asian developing countries in total, and to the Asian country groupings by the Asian developing countries as a whole and by country groups supports this conclusion, which, in turn, suggests that future trade patterns will be based on the evolution of comparative advantage.

In addition to generally conforming to the expectations based on relative resource endowments, intra-regional trade between the three Asian developing country groups and their trade with the entire region was seen to have been significant – greater than a 20 per cent share in many categories – for the NIC and Other ASEAN groups. Between these two groups and for South Asia – though still very small – the share of intra-regional and intra-South Asia trade was also growing. There is now sufficient interdependence *and* trade to lay the groundwork for trade expansion through liberalization. The prospects, given existing constraints and potential, are particularly good for South Asia, both as a market for human capital-intensive and some types of physical capital-intensive exports from the other Asian developing country groups and as an exporter of labor-intensive and some types of resource-based manufactures, especially to the NICs.

As the NICs move upmarket there should be scope for more labor-intensive imports from the Other ASEAN countries as well, the declining NIC share in such exports is evidence both of barriers and the potential for expansion if the barriers are removed. A similar argument applies to future NIC exports of physical capital-intensive goods to the Other ASEAN and South Asian countries.

With the existing differences in resource endowments, there seems to be scope for growth in intra-Asian developing country trade along the lines indicated. The present distortions would have to be removed, but the record suggests considerable potential. The varying resource endowments and stages of development, the wide shifts accomplished, especially by the Other ASEAN group, and the general conformity with comparative advantage suggest that the basis exists for trade expansion through liberalization, subregionally, regionally, or globally.

There seems to be a particularly strong possibility for increased intra-commodity class trade between Asian developing countries. The NIC and Other ASEAN groups have established relatively large shares in each other's human capital-intensive markets, but South Asia is so far excluded. However, India, for example, having taken advantage of the economies of scale and the competitive efficiencies possible in its large domestic market and its relatively large number of highly technically trained individuals, should have been in a position, if the markets were directing resources, to export larger shares of human capital-intensive goods to the Other ASEAN countries and the NICs. Similar opportunities for intra-industry or commodity class specialization and learning-by-doing exist in all the developing country groups if the policies are "right".

Implications for the Future

The determinants of trade and the variation in these determinants among the Asian developing countries, including physical and human capital intensities, agricultural and mineral resource endowments, the degree of industrialization, market size, and economic policies, suggest numerous possibilities for trade between Asian developing countries. The commonly expressed view that the Asian developing countries or various groupings of these countries are too similar to have much trade — a perception that contradicts long-run comparative advantage — is seen to be groundless. Where trade has developed between Asian developing countries, there is more openness or more emphasis on exports than where it has not. This is not to suggest, however, that there are no possibilities for improvement, especially in openness.

The structure of regional and of country exports, based on 16 commodity classes, reflects relative resource endowments and stages of development among Asian developing countries. Though other factors are involved, including natural resource endowments, import constraints, the oil shocks, and government interventions, the closest correspondence seems to be between actual trade structure and the trade structure expected on the basis of human and physical capital intensities. Thus, distortions have not been sufficient to move the structure of trade away from that expected on the basis of underlying trade determinants, though South Asia comes close in its emphasis on physical capital-intensive exports with physical capital-intensity indices far below average.

The shares of exports by destination across the Heckscher-Ohlin commodity classes confirm the general agreement of the trade structures and changes in trade structures by destination with those expected on the basis of comparative advantage. The geographic composition of exports also indicates the widely varying trade experiences of the three Asian developing country groups in different markets and the fact that in many commodity classes they are already important markets for each other. This is especially true for trade between the NICs and between the NICs and the Other ASEAN group, with NIC exports to Other ASEAN countries growing. It is also clear that the share of NICs in Other ASEAN exports (e.g., of labor-intensive exports) has not increased as expected.

Finally, this analysis shows that there is already a great deal of intra-commodity trade both between individual Asian developing countries and between the Asian developing country groups — outside South Asia — in the broad commodity classes covered. This indicates that specialization and learning-by-doing in like products are possible sources of increased trade in Asian developing countries as they have been elsewhere.

Although these conclusions require study at a much more disaggregated level and for longer periods, they seem to provide a sufficient basis for considering the likely future development of trade of Asian developing countries. As long as trade barriers do not markedly increase and quantitative restrictions are reduced or replaced with tariffs, the future evolution of trade is likely to follow the evolving Heckscher-Ohlin patterns over the next decade or to the year 2000. This implies that growth in trade to industrial countries initially will be at a slower rate than to developing countries. However, limits on the growth of trade to developing countries due to existing, and likely, quantitative barriers will tend to shift exports back toward the industrial countries where their rate of increase will be limited in the ways described earlier in this article. In general, the rate of increase in exports will tend to decline relative to the 1960s and 1970s.

Under these circumstances, the probable future patterns of trade by region can be discerned. The NICs are moving upmarket rapidly and will export more and more sophisticated human and physical capital-intensive goods to each other and to the other Asian developing countries, especially to Other ASEAN countries and the People's Republic of China. In some mass-produced capital-intensive consumer goods, the NICs have already penetrated the United States market, and this can be expected to continue though constrained by "voluntary" export-restraints. Labor-intensive exports should fall, relatively and then absolutely, partly because of changing factor endowments and partly from the "bite" of the Multi-Fiber Arrangement (MFA). In aggregate, the NICs may become significant net importers of labor-intensive goods. The movement of basic industries to the NICs will be surpassed by their movement out by the end of the period envisaged as human capital-intensive goods replace physical capital-intensive goods in the product cycle. The composition of their exports to the developing countries should change accordingly. Agricultural and raw material exports through Singapore or culturally based food products from the other NICs and resource-based manufactures should hold their own, with those sectors combining above average capital intensity and learning-by-doing having the best performance. The NICs, because of the present level of their capital stock, existing rates of capital accumulation and population growth, and their general outward-looking orientation, will be in a position to diversify and increase exports at a relatively high rate to industrial countries, even if industrial country commercial policies respond, with a lag, by becoming more restrictive. However, the increasing NIC-ASEAN interface, including intra-industry trade, is a key relation and places considerable emphasis on ASEAN commercial policy in the future of the NICs. In the long run, having no real Ricardo goods, except possibly fishing, the NICs will have to become increasingly industrialized and acquire a growing emphasis on human capital. These expected future outcomes assume physical and human capital accumulation at a rate relative to population growth that closes the capital-intensity gap with industrial countries and increases it relative to developing countries.

Based on the continued evolution of capital intensity at a rate slower than for the NICs but more rapid than for South Asian and most other developing countries, the expected movement of trade in the Other ASEAN countries away from primary products to manufacturing products will generally be slow, but positive. By the end of the century, manufacturing should be the dominant sector in the Other ASEAN countries. Well before then, labor-intensive and human capital-intensive exports should increase rapidly, both to the NICs and the industrial countries, especially Japan. Human capital-intensive exports to non-Asian developing countries should also increase. These outcomes will be influenced by trade barriers and the relative lack of flexibility of the Other ASEAN countries.[30] The latter, in turn, results from the lower stage of development so far achieved and, in most Other ASEAN countries, from the more inward-looking and restrictive policies followed. This situation makes the Other ASEAN countries more vulnerable to trade policy changes outside the region. Compared with less advanced developing countries, the Other ASEAN countries should have an increasing advantage in exporting physical capital-intensive goods, especially to less advanced countries. Exports of resource-based manufactures, a mainstay of Other ASEAN exports in the past, should decrease as long as commodity prices fall. And commodity prices seem at best unlikely to reverse their present downward trend until the early 1990s. The demand for many of these goods, especially for metals (tin, copper, aluminum), is relatively price inelastic. Growth depends on income growth, which gave the NICs a rapidly increasing share of Other ASEAN exports of these goods. In the future, prospects for this still dominant part of Other ASEAN exports are likely to continue to depend significantly on how well the NICs fare.

The South Asian countries had and are likely to have, unless there are major changes in commercial policy, a greater emphasis on the ROW, on barter trade, and on other developing country markets than the NICs or Other ASEAN countries. They can continue to sell textiles, primary products, and some physical capital-intensive goods to these markets. This has little relation to the Heckscher-Ohlin characteristics of South Asia, which is dominated statistically by its largest member, India. Rather, these outcomes represent the effect of Indian (and to some extent Pakistan) planning and the greater emphasis on barter trade in South Asia. Because of barriers, there is very little intra-regional or intra-Asian developing country trade for South Asia except in physical capital-intensive goods. These are exported to the Asian developing countries, instead of the seemingly more likely labor-intensive goods, because of domestic policies in South Asia and barriers against the latter in the Asian developing countries. The market in the NICs for labor-intensive and in the NICs and Other ASEAN countries for selected resource-based manufactures or primary products offers considerable opportunity for future development. Meanwhile, the South Asian countries must depend on growth in the EEC and on other developing countries, mostly in the Middle East. These two regions account for most of the market-determined portion of South Asia's major exports, food, textiles, raw materials, other resource-based manufactures, and clothing. As noted earlier, the ROW, on a barter basis, is also important in most of these markets. Without changes, the prospects for South Asian exports are not bullish, except for raw materials to Japan. These countries have been relatively more oriented to regions that have been growing more slowly than average and, in the manufacturing sector, to products greatly affected by "voluntary" export-restraints and/or direct protection or by the decline in commodity prices.

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[30] For evidence that trade barriers were less significant than world economic growth and domestic policies in explaining ASEAN's export performance, see D. DeRosa and B. Campbell, "Increasing Protectionism and Its Implications for ASEAN-US Economic Relations", paper presented at Workshop on ASEAN-US Economic Affairs organized by the Institute of Southeast Asian Studies, San Francisco, September-October 1986.

Since the People's Republic of China was not a major trading economy and only minimal data were available, it was not included in this analysis. There is insufficient relevant time series data to discuss factually and on a comparable basis the country's patterns and likely trends of trade. However, Heckscher-Ohlin considerations suggest that the People's Republic of China could well be a major exporter of labor-intensive goods. In the future, the country could be effectively competing with Other ASEAN and South Asian countries in the industrial country and NIC markets for these goods and it may become competitive in some resource-based manufactures. Except for oil, the People's Republic of China would not seem to be able to export large quantities of primary products or, except in special cases, export human or physical capital-intensive goods. But it could provide a good market for one or both of these categories for the NICs, Other ASEAN and South Asian countries.

These likely trends for the exports of Asian developing countries would take place in the framework described earlier in this article. That is, in an environment where the growth in exports to industrial countries will be increasingly limited by industrial country economic growth rates and the expansion in trade between developing countries continues to be limited by trade barriers. These barriers are often the result of the use of commercial policy by developing countries to solve balance of payments problems. However, if these barriers can be removed, trade between developing countries is the major possibility for increasing trade in the long run more rapidly than growth in the world economy. Ultimately, there would be a slowdown. But that would not be a negative outcome, rather a sign that all countries were becoming "developed" and moving toward taking full advantage of international specialization, leaving capital accumulation and technical and managerial change to account for most further growth.

Different scenarios using various models, usually estimated in an implicitly static fashion, have been presented for the effects on income of trade liberalization between developing countries. The gains vary from relatively small to quite large,[31] and would in all cases be larger than estimated if the commonly ignored dynamic benefits of open trade — which historically seem to offer the major gains — were included. Both on a priori grounds and in terms of the available empirical studies, a strong case can be made for trade liberalization. This is so, in a less than perfect world, even if liberalization is regional and involves trade diversion. On dynamic economic grounds and in terms of the political economy of trade policy, this may be the best route to higher world income and more open world trade in the future.

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[31] United Nations Industrial Development Organization, *Industry and Development, Global Report 1985* (New York, 1985).

EEC Trade Policies towards Asian Developing Countries

Rolf J. Langhammer*

In recent years, there has been growing international concern about protectionist tendencies in industrial countries against exports from the developing world. Estimates show that during the early 1980s, protectionist measures covered an increasing extent of the exports of developing countries. The evidence indicates that compared with Japan and the United States, the European Economic Community (EEC) has the highest relative level of manufactured imports facing non-tariff barriers and also the greatest increase of such trade restrictions.[1] This may seem to suggest that the high rates of unemployment and the keen competitiveness of imports in recent years prompted the EEC countries to respond to the demands for protection from domestic labor organizations and producers. Such a view, however, would be misleading. Rather, protectionism in the EEC must be considered as a part of the process towards the formation of a customs union.

The removal of customs requirements on trade among EEC countries and an agreement on a common tariff for their external trade called for a compromise between the more outward-looking and the relatively inward-looking member countries. This implied a higher average level of protection than if only the outward-oriented countries, such as the Benelux states (Belgium, Luxembourg and the Netherlands) and the Federal Republic of Germany, had formed a customs union. However, the acknowledgment of national interests and recognition of national policies have not only influenced the common protection level but also allowed the introduction of national escape clauses and safeguards on a temporary or permanent basis.

The initiatives of the more outward-looking countries to lower the common protection level on external trade often failed because of the impending threat to the internal free market. Threats by inward-looking countries to retaliate against the outward-looking members which assumed a liberal posture towards third countries proved very effective because it was the outward-looking countries that benefited most from the internal free market. This meant that the costs of the flourishing exports of these countries were borne by both EEC consumers and producers in third countries. One of the groups of third countries affected by EEC trade policies has been developing Asia.

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[1] See, for example, Julio J. Nogués, Andrzej Olechowski and L. Alan Winters, *The Extent of Non-Tariff Barriers to Industrial Countries' Imports*, Discussion Paper, no. DRD 115 (Washington, D.C.: World Bank, January 1985); and Bela Balassa and Carol Balassa, "Industrial Protection in the Developed Countries", *The World Economy* (June 1984), pp. 179-196.

This article attempts to show how the exports of Asian developing countries to the EEC have been hampered by EEC trade policies. It first assesses the importance of the EEC market for Asian developing countries and outlines the major changes that have occurred over the years. It then analyzes the major factors that have influenced the overall EEC trade policy towards Asian developing countries and draws some conclusions. Finally, it comments on the costs of protectionism and discrimination in EEC trade policy.

The EEC Market for Asian Exports

The importance of the EEC as an export market for Asian developing countries may be discerned from the trend of two major indicators of their export performance. The first relates to the share of their exports in EEC non-oil imports originating outside the EEC. During 1970-1984, this share doubled with gains being highest in manufactured goods (see Table 1). The increases in the

Table 1: **Share of Asian Developing Country Exports in EEC Imports Originating Outside the EEC, 1970 and 1984**
(Percentages)

Commodity Class	1970	1984
Food, Beverages and Tobacco	5.5	9.2
Crude Materials	7.7	8.2
Fuels	0.6	0.2
Chemicals	0.6	1.9
Manufactured Goods other than Machinery and Transport	11.3	20.8
Non-Ferrous Metals	2.4	4.7
Clothing	40.9	45.3
Machinery and Transport Equipment	0.9	8.2
Total (excluding oil)	5.2	10.4

Notes: Commodity classes refer to Standard International Trade Classification (SITC). The Asian developing countries include Afghanistan, Bangladesh, Brunei, Burma, Hong Kong, India, Indonesia, Republic of Korea, Lao People's Democratic Republic, Macau, Malaysia, Maldives, Nepal, Pakistan, Philippines, Singapore, Sri Lanka and Thailand. The EEC countries include Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, and the United Kingdom.

Source: Calculated from *Monthly Bulletin of Statistics* (New York: United Nations, February 1985, May 1985, February 1986 and May 1986).

trade shares led to corresponding losses mainly in competing developing regions and, to some extent, among exporters in developed countries. It is noteworthy that the Asian developing countries were not only able to maintain their competitiveness in products, such as clothing, in which they were leading in the 1970s, but they also became competitive in new products, such as machinery and transport equipment.

The second indicator of the export performance of Asian developing countries to the EEC refers to the relative shares of exports to the major trading countries or regions. The trend of this indicator shows that the EEC has become less important as an export market for all goods, except machinery and transport equipment, from Asian developing countries (see Table 2). During 1970-1984, the share of the EEC in total non-oil exports from Asian developing countries decreased from about 18 per cent to about 14 per cent, and in total exports, including oil, from 17 per cent in 1970 to about 11 per cent. Total non-oil exports to the United States increased from 24 per cent to 32 per cent. While trade among the Asian developing countries ranked second to the United States in absolute terms, the increase in the share of the Middle East countries was particularly significant. The decline in the importance of the Japanese market for non-oil exports from developing Asia is noteworthy. This market was increasingly absorptive for food products and non-ferrous metals but there was stagnation or a relative decline in all other commodities.[2]

The evidence indicates that there was a decline in the relative share of the EEC market, which accounted for less than 14 per cent of total non-oil exports from Asian developing countries in 1984. This trend, however, should not minimize the importance of EEC trade policies towards developing Asia. Table 2 shows that the change in the structure of Asian exports in recent years, involving increased exports particularly of electrical, non-electrical and electronic machinery, is reflected in the growing EEC market for these products. Although the structural change may not affect the exports of all Asian developing countries, EEC trade policies have an impact on all these countries. They are either adversely affected by obstacles to their agricultural exports that compete with EEC products or positively affected by the opening of the EEC market to non-traditional products.

Elements of EEC Trade Policies

The EEC was established in 1957 by the Benelux states, France, Federal Republic of Germany and Italy. Since 1968, the responsibility for trade policies

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[2] This reflects the changing direction of sales in the 1970s of Japanese subsidiaries operating in the Asian developing countries. There was a shift from their exports to Japan to local sales or exports to third countries. See Ulrich Hiemenz and Rolf J. Langhammer, *Efficiency Pre-Conditions for Successful Integration of Developing Countries into the World Economy*, World Employment Programme Working Paper (Geneva: International Labour Office, forthcoming).

Table 2: **Direction of Exports of Asian Developing Countries**

(Percentages)

Commodity Class	United States		Japan		EEC		Australia, New Zealand		Centrally Planned Economies		Middle East Countries		Asian Developing Countries		Other Destinations	
	1970	1984	1970	1984	1970	1984	1970	1984	1970	1984	1970	1984	1970	1984	1970	1984
Food, Beverages and Tobacco	19.7	12.6	12.8	21.6	20.8	14.8	1.8	1.9	8.2	7.3	4.9	12.4	24.6	19.5	7.2	9.9
Crude Materials	10.3	10.7	30.4	23.3	19.4	14.2	1.2	1.0	11.0	9.7	1.1	3.4	20.0	29.4	6.6	8.3
Fuels	7.1	13.6	29.8	44.1	4.9	0.6	6.6	3.0	11.1	1.2	0.2	1.1	36.3	31.1	4.0	5.3
Chemicals	5.0	9.6	13.7	12.0	5.8	7.4	2.9	3.2	10.8	10.3	2.9	2.9	50.0	46.0	8.9	8.6
Manufactured Goods other than Machinery and Transport	36.0	40.7	5.7	6.5	18.0	15.0	3.2	2.9	5.6	4.8	2.6	6.3	13.5	13.1	15.4	10.7
Non-Ferrous Metals	37.7	16.0	21.3	29.9	22.6	15.8	0.2	0.5	3.7	7.4	1.9	1.2	6.5	27.0	6.1	2.2
Clothing	46.4	52.6	6.7	6.5	23.3	19.4	1.2	1.5	0.3	1.5	2.0	4.5	2.6	2.1	17.5	11.9
Machinery and Transport Equipment	41.0	41.8	4.8	4.5	8.4	12.4	1.0	1.6	1.7	5.8	2.4	2.6	29.8	21.3	10.9	10.0
Total Non-Oil Exports	24.4	32.5	15.3	10.5	17.9	13.7	2.1	2.2	7.5	6.2	2.8	5.7	19.7	19.4	10.3	9.8
Total Exports	23.1	29.0	16.3	16.7	17.0	11.3	2.4	2.3	7.8	5.4	2.6	4.8	20.9	21.5	9.9	9.0

Notes: Commodity classes refer to Standard International Trade Classification (SITC). The Asian developing countries include Afghanistan, Bangladesh, Brunei, Burma, Hong Kong, India, Indonesia, Republic of Korea, Lao People's Democratic Republic, Macau, Malaysia, Maldives, Nepal, Pakistan, Philippines, Singapore, Sri Lanka and Thailand. The EEC countries include Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, and the United Kingdom. The Middle East Countries include Bahrain, Cyprus, People's Democratic Republic of Yemen, Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, Turkey, United Arab Emirates and Yemen Arab Republic. The centrally planned economies include Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania, Union of Soviet Socialist Republics, People's Republic of China, Democratic People's Republic of Korea and Viet Nam.

Source: Calculated from *Monthly Bulletin of Statistics* (New York: United Nations, February 1985, October 1985 and May 1986).

has been vested in the EEC Commission located in Brussels, the executive organ of the EEC. In that year, all tariffs on intra-EEC trade were removed and common external tariffs were introduced. Non-tariff barriers on intra-EEC trade have also been reduced, but some still exist especially if different national technical standards, health regulations and subsidies are considered. The new members, Portugal and Spain which joined the EEC in 1986, have to adjust to the common external tariff and cut their tariffs against the other members within seven years for industrial goods and ten years for agricultural products. This implies that Portugal and Spain must adopt EEC's trade policies towards developing countries. The EEC has deviated widely from the non-discrimination principle of the General Agreement on Tariffs and Trade (GATT) and it applies different policies to different regions and trading blocs. Although this regionalism has its roots in special trade relations between individual EEC countries and their former colonies, the EEC itself has always advocated different regional trade policies with a development aid rationale.

In the past, the access of developing country exports to the EEC has been generally determined by four basic elements of trade policy. The first element relates to government assistance to aging industries in all EEC countries and is reflected in the common protection level enjoyed by industries in these countries. The second concerns demand for additional protection in favor of industries in individual member countries. This has caused explicit or implicit deviations from the common protection level mostly on a temporary but also on a permanent basis. The third consists in delinking EEC agriculture from international competition and fluctuations in prices. This is reflected in the Common Agricultural Policy (CAP) introduced in 1966 with internal price and purchase guarantees, on the one hand, and adjustments of international prices to the EEC price level, on the other. The fourth element relates to EEC's policy favoring non-member countries and trading blocs such as the African, Caribbean and Pacific (ACP) countries, the countries of the Mediterranean rim and members of the European Free Trade Association (EFTA).[3] This is reflected in the complex network of discriminatory tariffs through generalized and country-specific or region-specific trade preferences. These four elements affect the access to markets by both the privileged and non-privileged developing countries and in absolute as well as relative terms.

Four major factors have influenced EEC policies on exports from Asian developing countries. First, as indicated earlier, these countries have been relatively successful in expanding their exports to the EEC. Their export dynamism was based mainly on an inter-industry division of labor between the EEC and Asian countries. This entailed a one-way trade in different industries rather than exports *and* imports in the same industries which would have occurred if there was an intra-industry division of labor.[4] Inter-industry division of labor may be a greater threat to the survival of industries than intra-industry division of labor. This encouraged EEC trade unions, in coalition with domestic producers, to lobby for industry-specific protection measures when export markets were lost and import competition became stronger. Industries such as clothing and footwear received political support mainly to the detriment of Asian developing countries which specialized in a limited range of labor-intensive industries compared with developing countries in Latin America and sub-Saharan Africa. As a result, the overall EEC protection level in the manufacturing sector against developing Asia has exceeded that against the other developing regions.

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[3] EFTA was established in 1959 and its initial members were Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom. In 1961 Finland was associated with EFTA. Denmark, Portugal and the United Kingdom had to leave EFTA because of their accession to EEC. Members of EFTA have abandoned barriers on intra-EFTA trade while maintaining national external tariffs.

Second, both the level of competitiveness and the adjustment efforts to regain competitiveness in industries under strong competition have varied greatly among EEC countries. For example, the textile industry in Italy tried to adjust by focusing production on high-quality fashion clothing, while industries in the Federal Republic of Germany and the Netherlands engaged in the production of clothing in Mediterranean and socialist countries with the home industries focusing on more capital-intensive production of fibers and fabrics for industrial use. The textile industry in France tried to protect its whole range of production of yarn, fabrics and clothing. It therefore advocated the introduction of a threshold price system with variable levies against textile imports from developing countries similar to that of the CAP.[5] However, this protectionist measure was not approved by the EEC. Moreover, young industries such as, for instance, in Ireland pleaded for "infant-industry" protection. As a result, deviations from the common protection level have been increasingly demanded by member countries and approved by the Commission. These occurred not only through EEC member quotas in the Multi-Fiber Arrangement (MFA) but also through a growing number of approvals to apply Article 115 of the EEC Treaty.[6] Most of these national protection measures have been imposed on imports from Asian developing countries.

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[4] A typical case of inter-industry division of labor is clothing. While the ratio of exports to imports of Asian developing countries to and from the EEC in 1970 was 3:1, this ratio for clothing rose to 29:1 in 1983. Trade unions and producers in EEC countries generally have not accepted the argument that inter-industry specialization is intrinsic to trade between countries at different income levels and with varying resource endowment, nor that it is unrelated to "unfair" competition. Also, they do not endorse the view that changing locational advantages of certain industries simply reflect structural changes in the world economy and constitute the price for increasing real incomes in *all* countries participating in the international exchange of goods and services.

[5] Conseil Economique et Social, "Le Devenir des Industries du Textile et de l'Habillement", *Journal Officiel de la République Francaise*, Avis et Rapports du Conseil Economique et Social, Annee 1982, no. 5 (25 Fevrier 1982).

[6] Article 115 allows for a temporary exemption from the common trade policy in order to enforce national measures against indirect imports through other EEC countries. However, as such trade deflection violates a basic principle of the EEC, i.e., the free movement of goods, the Commission opposed the request from France for an automatic application of this national safeguard clause. Instead, the Commission considers that Article 115 should be limited to cases where trade deflections entail "economic difficulties" in member countries receiving re-exports. However, because of difficulties in assessing the real impact of indirect imports, the Commission has often accepted the argument of member countries that such imports would aggravate the risk of economic difficulties and has consequently approved the application of Article 115.

Third, the CAP has a direct bearing on agricultural exports from Asian developing countries. As discussed later in this article, discriminatory measures against Asian agricultural products that compete with products from ACP countries have, to some extent, restrained the growth of export revenues in some Asian developing countries.

Fourth, all the Asian developing countries are excluded from special EEC trade preferences.[7] They, therefore, receive benefits only from the Generalized System of Preferences (GSP). The EEC has established commercial cooperation agreements with Bangladesh, India, Pakistan, Sri Lanka and the Association of Southeast Asian Nations (ASEAN). These offer no opportunity for access to markets but merely provide for consultation in trade policy disputes. The non-privileged status of the Asian developing countries became most evident after 1973. The membership of the United Kingdom in the EEC entailed a phasing-out of Commonwealth preferences and their replacement by the GSP scheme of the EEC, which was less liberal than the former GSP scheme of the United Kingdom, and also by the EEC preferences for the ACP Commonwealth countries. The Asian member countries of the Commonwealth – Bangladesh, Hong Kong, India, Malaysia, Sri Lanka and Singapore – incurred a sizable erosion of their access to the United Kingdom market. This loss was only partly compensated by tariff concessions for some processed agricultural goods which were important export items for the Asian Commonwealth countries in the GSP scheme of the EEC.[8]

EEC Common Protection against Industrial Exports of Asian Developing Countries

The level of EEC common protection against Asian developing countries is determined largely by non-tariff barriers and, to some extent, by tariffs. The MFA framework is the most relevant non-tariff barrier to exports from Asian developing countries.

The GATT-based multilateral trade negotiations and the GSP have helped to erode the protective effects of tariffs. Table 3 shows average weighted nominal tariff rates of between 6 per cent and nearly 8 per cent on imports from developing countries in 1982, which differ only slightly among the Newly Industrializing Countries (NICs) and middle-income countries. The differences arise from the different weight of goods classified as "sensitive" in the exports of develop-

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[7] Philip Mishalani, Annette Robert, Christopher Stevens and Ann Weston, "The Pyramid of Privileges", in Christopher Stevens, ed., *EEC and the Third World* (London: Hodder and Stoughton, 1981), pp. 60-82.

[8] See Joint Declaration of Intent on the Asian Commonwealth Countries annexed to the Treaty of Accession of the United Kingdom. See also, Peter Tulloch, *The Seven Outside: Commonwealth Asia's Trade with the Enlarged EEC* (London: Overseas Development Institute, 1973); and Dharam P. Ghai, *The Enlargement of the EEC and the Asian Commonwealth Countries* (London: Commonwealth Secretariat, 1973). Both authors include Pakistan as an Asian Commonwealth member.

Table 3: **Weighted Average Rates of Tariffs for EEC Non-Oil Imports from Developing Countries, 1982**
(Percentages)

Country Group Affected	**All Products**	**Processed Agricultural Products**	**Industrial Products**
Group of 77	6.9	6.2	7.1
Newly Industrializing	7.3	6.3	7.9
Middle-Income	6.0	6.0	5.9

Note: Weighted by imports which do not receive preferential treatment.

Source: Axel Borrmah, Christine Borrmah, Christian Langer and Karl-Wolfgang Menck, *The Significance of the EEC's Generalized System of Preferences* (Hamburg: Weltarchiv, 1985), Table 37.

ing countries.[9] The NICs, which include some Asian countries,[10] face a higher level of nominal tariff protection than middle-income countries because of the stronger weight of sensitive goods in their exports. The implementation of the tariff reductions negotiated in the Tokyo Round and scheduled for the period 1982-1987 will result in a further reduction of the average weighted nominal tariffs to about 5 per cent for industrial products and 7 per cent for finished manufactured goods.[11]

This outcome in tariff reductions, however, may not be applicable to those countries that are highly competitive in sensitive products such as clothing and consumer electronic goods. The EEC has made marginal concessions for these products in the Tokyo Round despite a high prior tariff rate. For manyAsian developing countries, clothing and electronic goods form a substantial part of their total exports of manufactured goods to the EEC: 52 per cent for Hong Kong, 49 per cent for the Republic of Korea, 45 per cent for the Philippines and 39 per cent for Singapore. The average nominal tariff rate imposed on imports from these countries is likely to be 10 per cent or higher.

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[9] Sensitive products are those for which domestic production is very vulnerable to import competition and which are given the highest protection. They include, for instance, textiles, clothing, footwear, leather goods, radios and toys.

[10] The Asian developing countries classified as NICs in the study from which Table 3 is obtained include Hong Kong, Republic of Korea, Malaysia, Philippines, Singapore and Thailand. The import-weighted average tariff rates exclusively for Asian developing countries have not been given in the study. However, considering the share of Asian countries in EEC imports of manufactured goods, it is likely that the estimates for these countries will approximate the figures in Table 3.

[11] General Agreement on Tariffs and Trade, *The Tokyo Round of Multilateral Trade Negotiations*, vol. 2, Supplementary Report (Geneva, 1980), Table 2.

However, it is the effective tariff rate — i.e., the protection of the domestic value added — that has greater relevance in tariff protection. The nominal rate merely shows the percentage by which the domestic price of a product exceeds the international price. It does not indicate the extent to which domestic production is protected from international competition. To measure this protection, the value added of a specific stage of processing at domestic prices must be compared with the value added at international prices, i.e., under conditions of free trade. Differences between the nominal and effective rates are determined by the rise of nominal tariffs over the various processing stages from the raw material to the finished product.[12]

Table 4 shows that despite formulas for the harmonization of tariffs negotiated in the Tokyo Round, effective tariff rates calculated for the Federal

Table 4: **Nominal Tariffs for EEC and Effective Tariffs for Federal Republic of Germany on Selected Products**
(Percentages)

Product	**Pre-Tokyo Round Tariff**			**Post-Tokyo Round Tariff**		
	Intermediate Goods	**Finished Goods**	**Effective Rate**	**Intermediate Goods**	**Finished Goods**	**Effective Rate**
Cotton Fiber	5.4	6.0	6.9	4.4	5.5	7.2
Cotton Yarn	6.1	7.4	9.6	4.6	6.2	8.8
Cotton Fabrics	6.8	13.3	22.6	5.1	9.3	15.3
Bed Linen, Table Linen	11.8	17.0	25.5	8.6	14.0	22.9
Clothing	10.9	19.0	32.3	7.7	13.0	21.8
Television Sets, Radios, Sound Recorders	9.4	14.0	24.8	7.0	14.0	29.1
Rubber Boots	6.2	20.0	42.0	4.1	20.0	45.4
Knives, Cutlery	6.4	18.0	30.5	4.6	17.0	30.5

Source: Horst Werner and Dorit Willms, *Zollstruktur und Effektivzolle nach der Tokio-Runde. Die Auswirkungen der Tokio-Runde auf die Tarifeskalation und die Effektivzolle der Bundesrepublik Deutschland und der EG* (Koln: Institut fur Wirtschaftspolitik an der Universitat zu Koln, 1984).

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[12] To illustrate, let us assume raw jute is imported duty-free at $80 per unit and jute yarn produced from raw jute costs $150 per unit under free trade and is charged a tariff of 8 per cent. If a yarn producer imports raw jute, there is no tariff charge, but if jute yarn is imported, the collected tariff is $12 (8 per cent of $150). Thus, at the value added of $70, the collected tariff of $12 is 17.1 per cent of this value added. The domestic producers of jute yarn are, therefore, effectively protected at a rate of 17.1 per cent and not at the nominal rate of 8 per cent.

Republic of Germany have continued to be higher than nominal tariffs.[13] This has been observed for product categories in which Asian developing countries have built up export strongholds. For some products, such as consumer electronic goods, the effective tariff protection was higher even after the Tokyo Round because tariffs on intermediate inputs were reduced but not on finished products. Effective rates for textiles decreased but they remained above 20 per cent for finished goods. This situation of decreasing effective rates being higher than nominal rates is valid for most of the manufactured goods exported by Asian developing countries to the EEC. The Tokyo Round, therefore, has not led to the removal of discrimination against exports of finished goods from developing countries.

The main concern, however, is the intricate system of non-tariff barriers maintained by the EEC. The available estimates by the United Nations Conference on Trade and Development (UNCTAD) indicate that in the mid-1970s more than 50 per cent of the exports of Hong Kong, Republic of Korea and Pakistan to the EEC were subject to major non-tariff barriers (see Table 5). For the countries listed in Table 5, this share represented one-third of their aggregate imports, exceeding the corresponding shares of the imports of Japan and the United States from these Asian developing countries.

The volume of imports, however, that is subject to non-tariff barriers in the EEC countries is not indicative of the influence of these barriers on prices. Estimates have been made which indicate that domestic prices in EEC countries have been substantially higher than international prices and that only part of the difference could be explained by nominal tariffs, transport costs and other border charges.[14] The estimates suggest that non-tariff barriers imposed by EEC countries are effective and even exceed nominal tariffs in terms of price effects. The core of non-tariff barriers of the EEC countries consists of quantitative restrictions introduced under bilateral agreements within the MFA framework and which directly affect exports from Asian developing countries.

It is noteworthy that during 1979-1982 the exports of MFA products from Asian developing countries (except Pakistan) to the EEC were less than the quotas (see Table 6). The declining rate of utilization of quotas is indicative of the increasing costs of information and uncertainties arising from the large number of quotas and ceilings imposed on EEC countries. For most MFA products, the ceilings can be converted into quotas unilaterally or after consultations. This instability in the access to markets creates uncertainties for exporters, leads to depreciation of the capital stock in industries, and hinders the flexibility of

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[13] In Table 4, the EEC tariffs have been applied to the input-output structure of the Federal Republic of Germany. However, in the light of similarities in the input-output structures of EEC countries, the rates of effective protection estimated for the Federal Republic of Germany may well be applicable to the other EEC countries.

[14] See, for example, Vernon Roningen and Alexander Yeats, "Nontariff Distortions of International Trade: Some Preliminary Empirical Evidence", *Weltwirtschaftliches Archiv*, vol. 112, no. 4 (1976), pp. 613-625; Irving B. Kravis, Alan Heston and Robert Summers, *World Product and Income: International Comparisons of Real Gross Product* (Baltimore: Johns Hopkins University Press, 1982); and Frank D. Weiss, "Importrestriktionen der Bundesrepublik Deutschland", *Die Weltwirtschaft*, no. 1 (1985), pp. 88-100.

Table 5: **EEC Non-Tariff Barriers against Imports from Selected Asian Developing Countries, 1974**
($ million)

Exporting Countries	**Imports Subject to Non-Tariff Barriers**					**Share of Total Imports**
	Export Restraints	**Licensing and Quotas**	**Health Regulations**	**Variable Levies**	**Total**	**(%)**
Bangladesh	9.9	23.0	0.3	—	33.2	32.7
Hong Kong	749.4	200.8	2.0	2.1	954.3	64.0
India	179.3	121.5	39.0	7.7	347.5	33.6
Indonesia	0.5	3.6	7.1	0.5	11.7	2.1
Korea, Rep. of	207.6	90.8	4.4	0.4	303.2	55.8
Malaysia	16.9	5.0	1.5	0.7	24.1	2.3
Pakistan	128.2	36.5	1.4	11.3	177.4	60.8
Philippines	5.6	1.6	101.0	1.1	109.3	35.4
Singapore	32.2	29.9	1.8	0.3	64.2	15.5
Sri Lanka	0.6	2.6	1.3	0.0	4.5	2.9
Thailand	10.3	5.7	2.6	24.8	43.4	10.2
Total	1,340.5	521.0	162.4	48.9	2,072.8	32.6
Imports of United States from Selected Asian Countries	1,047.0	1,800.8	98.4	—	2,946.2	19.7
Imports of Japan from Selected Asian Countries	—	2,183.9	4.5	—	2,188.4	21.9

— = nil.

Source: *Handbook of International Trade and Development Statistics* (New York: UNCTAD, 1979).

industries to respond quickly to changes in demand patterns. The average utilization of quotas in MFA exports from Asian developing countries to the EEC fell from about 61 per cent in 1979 to about 51 per cent in 1982. In addition, the MFA has helped to generate "rents" for established producers to the detriment of newcomers. This was clearly demonstrated in 1984 and 1985 when the Commission introduced quotas for exports of shirts from Bangladesh to France and the United Kingdom. Such quotas were imposed on the grounds of a too rapid expansion of exports to an EEC country, though in 1984 exports of clothing from Bangladesh to France and the United Kingdom represented only 1.5 per cent

Table 6: **Average Utilization Rates of Quotas by Asian Countries in EEC Imports of Textiles and Clothing under MFA, 1979-1982**
(Percentages)

Country	**1979**	**1980**	**1981**	**1982**
Hong Kong	68.2	65.8	59.6	52.6
India	66.8	71.4	62.0	51.6
Indonesia	..	..	74.1	72.5
Korea, Rep. of	75.0	69.5	70.0	61.7
Macau	74.0	67.4	61.1	66.8
Malaysia	65.6	63.3	56.9	51.0
Pakistan	53.6	77.9	60.0	68.5
Philippines	73.4	86.7	74.3	66.2
Singapore	69.9	63.2	52.6	40.2
Sri Lanka	44.6	69.2	56.3	41.8
Thailand	81.6	107.4	74.6	74.6

.. = not available.

Source: *Textiles and Clothing in the World Economy,* (Geneva: GATT, July 1984), Table 3.13.

of similar exports from Hong Kong.[15] These discretionary actions jeopardize the efforts to diversify exports and to stimulate domestic and foreign investment in sectors where Asian newcomers could prove to be competitive.

The escalation of nominal tariffs does not seem to have been eliminated through GATT-negotiated tariff cuts. Many exports of manufactured goods still face higher effective rates of protection than indicated by nominal tariffs while non-tariff barriers persist. Short-term discretionary changes in the conditions of market access within the MFA framework have led to high risks of investments in textiles and clothing, thus impeding the flow of investment resources. Among exporting countries, newcomers have been discriminated in favor of established producers, thus hindering the relocation of productive capacities among Asian developing countries and slowing down changes in the sectoral structure within these countries.

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[15] The rapid increase in exports from Bangladesh may be partly because large Asian textile producers were using Bangladesh to circumvent EEC quotas.

National Deviations from EEC Common Trade Policy

Although EEC member countries have transferred juridical authority for trade policy issues to the Commission, there are numerous cases in which national interests encouraged the retention of national authority. In these cases, national surveillance of exports was retained, which enabled a member country to introduce safeguards independently of the Commission. The most important products for which national rights to control imports were not surrendered were oil products. It is estimated that at the end of the 1970s, about 21 per cent of the total non-oil imports of the EEC consisted of goods that were not liberalized at the Community level, which entailed that at least one member country had national control.[16] France and the United Kingdom were the main countries which maintained national surveillance (about 12 and 11 per cent, respectively, of their non-oil industrial imports from developing countries in 1978).

Apart from the sentiment of sovereignty in retaining national control of imports, there has been use of Article 115, indicated earlier, to meet temporary difficulties experienced by a member country. The number of applications for "emergency" measures under Article 115 approved by the Commission increased from 63 in 1977 to 167 in 1983.[17] Most of the national restrictions against direct and indirect imports were on goods originating in Asian countries and in respect of Asian developing countries on textiles, clothing and consumer electronic goods.[18] During 1981-1985, France and Ireland accounted for most of the applications approved by the Commission against exports originating in Asian developing countries (see Table 7).

The beneficiaries of protectionist measures are aging industries, such as the textile and clothing industries in France, and infant industries, such as those in Ireland. However, protectionist actions by individual EEC countries are not taken at the industry level but on products and product lines. This suggests that marginal producers with specific patterns of specialization, rather than industries, are intended to be protected against outside competition. The protectionist measures applied for under Article 115 are aimed at preserving intra-industry specialization within the EEC. For example, the large EEC-based textile and clothing industries relocated their labor-intensive operations in Ireland, which is reflected in the large number of requests for protectionist measures by firms in Ireland against competing products from Asian developing countries. Article 115, therefore, has served to protect intra-EEC specialization but, as a result,

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[16] Rolf J. Langhammer, "Nationaler Protektionismus im Rahmen der EG-Handelspolitik, dargestellt am Beispiel der Industriegüterimporte aus ASEAN-Landern", *Die Weltwirtschaft*, no. 1 (1981), pp. 74-93.

[17] Georg Koopmann, "National Protectionism and Common Trade Policy", *Intereconomics* (May/June 1984), pp. 103-110.

[18] During 1977-1983, 15 per cent of the total applications were directed against exports from Hong Kong, 14 per cent against the Republic of Korea, 13 per cent against Taiwan and 11 per cent against Japan. For a detailed analysis of the interaction between EEC's textile trade policy and the application of Article 115, see R.J.P.M. van Dartel, "The Conduct of the EEC's Textile Trade Policy and the Application of Article 115 EEC", in J.H.J. Bourgeois et al, *Protectionism and the European Community* (Deventer: Kluwer Law and Taxation Publishers, 1983), pp. 99-123.

Table 7: **Number of Applications Approved under Article 115 of EEC Treaty against Imports from Asian Developing Countries, 1981-1985**

Affected Country	EEC Member Country						EEC
	Germany, Fed. Rep. of	**France**	**Italy**	**Benelux**	**United Kingdom**	**Ireland**	
China, People's Rep. of	3	21	5	7	19	1	56
Hong Kong	—	22	1	4	1	65	93
India	—	6	3	—	—	12	21
Indonesia	—	1	—	1	—	1	3
Korea, Rep. of	2	24	4	4	7	23	64
Malaysia	—	7	—	1	1	—	9
Pakistan	—	11	3	—	—	7	21
Philippines	—	2	—	1	—	14	17
Singapore	—	2	—	—	—	—	2
Taiwan	—	36	1	12	9	20	78
Thailand	—	12	—	—	—	3	15
Total	5	144	17	30	37	146	379

— = nil.

Source: *Official Journal of the European Communities*, Series C, Information and Notices, current issues, Luxembourg.

the free movement of imported goods within the EEC has been hindered. In 1985, more than 50 per cent of the safeguard clauses of Article 115 were applied against Asian developing countries. Consequently, the free movement of their exports within the EEC market has come to a virtual standstill. It is unlikely that the enlargement of the EEC will change this situation as the new members, Portugal and Spain, as well as Greece, host industries which produce goods that compete with exports of Asian developing countries. The new EEC members may well claim exemptions from the common trade policy if they fail to adjust to import competition from third countries before they become subject to the common level of protection.

Protection against Agricultural Exports of Asian Developing Countries

There is a vast literature on EEC protection against agricultural exports of developing countries.[19] The empirical studies suggest that only a few Latin American countries exporting cereals and beef suffered directly from protectionism and subsidized exports of developed countries.

However, there has also been EEC protection against agricultural exports of Asian developing countries. The protection generally has taken three forms. First, there has been discrimination in tropical products, such as cocoa, palm oil, fruits, tobacco, coffee and wood, exported to the EEC by ACP countries. GSP provisions for these products include tariff quotas and ceilings to protect ACP exporters. Second, domestic suppliers have been protected through variable levies and other interventions on products such as sugar and rice. Surpluses of these products have also been released in world markets resulting in unstable and depressed prices in world markets. Third, quantitative restrictions have been imposed on imports of animal feed, such as cassava, which are substitutes for grain.

The restriction on cassava, which affects Indonesia and Thailand, highlights the two major elements of EEC protectionism, i.e., protection of local producers and discrimination between non-EEC producers of close substitute products. The competitiveness of cassava is mainly due to the CAP policy of keeping the EEC price of grain at an artificially high level, thus raising the competitiveness of grain substitutes for animal feed. The mixture of cassava pellets with soybean meal, which was not subject to variable import levies, therefore had the competitive edge on grains and could disturb the EEC-regulated grain market unless imports of cassava were also restricted. These measures, however, were introduced in a discriminatory manner. While the import of cassava from Indonesia and Thailand was regulated, another substitute, i.e., corn gluten feed, could be imported unrestricted from the United States. This preference given to the United States over imports originating in Asian developing countries was considered as compensation for losses incurred by the United States in world markets for agricultural products arising from CAP. As a result of "voluntary" restraint on exports and EEC aid for the production of alternative agricultural products, the volume of exports of cassava from Thailand to the EEC declined by 40 per cent after 1982. This entailed a loss of about $329 million, representing 11 per cent of Thailand's total earnings from exports to the EEC.

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[19] See, for example, Gary Sampson and Alexander Yeats, "An Evaluation of the Common Agricultural Policy as a Barrier Facing Agricultural Exports to the European Economic Community", *American Journal of Agricultural Economics*, vol. 59 (February 1977), pp. 99-106; Alberto Valdes and Joachim Zietz, *Agricultural Protection in OECD Countries: Its Cost to Less-Developed Countries* (Washington, D.C.: International Food Policy Research Institute, 1980); Ingeborg Menzler-Hokkanen, *EEC Trade Policies on Tropical Agricultural Products*, paper presented at the conference on ASEAN-EEC Economic Relations, Brussels, 16-18 September 1982 (Singapore: Institute of Southeast Asian Studies, forthcoming); and Alberto Valdes and Joachim Zietz, "The Potential Benefits to LDCs of Trade Liberalization in Beef and Sugar by Industrialized Countries", *Weltwirtschaftliches Archiv*, vol. 122, no. 2 (1986).

The EEC conducts its trade relations in a context that links specific concerns with larger policy issues. This has often had adverse implications for the country concerned. For example, the request of Thailand to maintain cassava exports at the reduced level was accepted by EEC only when Thailand was willing to sign the bilateral MFA agreement, thereby deviating from the initial stand of ASEAN in opposing such agreements. Notwithstanding EEC's discriminatory trade policy towards agricultural exports of Asian developing countries, the access to markets and export revenues have not been adversely affected in all cases. While privileged ACP countries experienced declines in EEC agricultural markets, non-privileged Asian countries were able to expand exports in competing products despite discriminatory trade preference, for instance, in vegetable oils.[20] However, direct controls of trade flows have hampered the expansion of ASEAN agricultural exports, though the adverse effects on export revenues appear to have been weaker than for some Latin American countries.

Trade Preferences and Unequal Treatment

Trade preferences aimed at exploiting comparative advantages would contribute to the expansion of world trade and economic growth, though perhaps at the expense of domestic producers. However, trade preferences granted with a "protectionist view" would divert imports in favor of trading partners, particularly those which cannot compete under a regime of equal tariffs.[21] Such diversion would be to the detriment of world economic welfare as high-cost producers would replace the more efficient low-cost ones. The evidence suggests that trade preferences under the EEC have been protectionist. For example, the ACP countries were granted a safeguard clause in the GSP; tariff quotas for sensitive goods were shared among EEC countries to serve their vested interests; and successful suppliers under the GSP were penalized by freezing the preferential exports of specific items. In general, considerations of distribution rather than allocative efficiency have determined EEC trade concessions.

In assessing GSP, the major criterion is whether it generates additional trade which would not have occurred without concessions. Empirical analyses based on different concepts of measurement have led to different conclusions, especially for the GSP scheme of the EEC which requires tariff quotas, ceilings and administrative conditions to be met before concessions are made.[22]

In the context of the Asian developing countries, the extent to which GSP removes an essential barrier to exports may be assessed by comparing the export performance of four countries, namely, Hong Kong, Republic of Korea, Singapore and Taiwan. Taiwan was denied preferential treatment by the EEC because of its non-membership in the Group of 77. Table 8, however, shows that before the GSP reform of 1981, which resulted in an implicit graduation of successful exporting countries, the performance of Taiwan was comparable with the three countries that enjoyed preferences. Moreover, its good export performance cannot be explained by a low starting base or a comparatively lower vulnerability of its exports to EEC import restrictions. Although Taiwan has not specialized in textiles to the extent of Hong Kong, Republic of Korea and Singapore, many of its other manufactures are as vulnerable to EEC protection as of these countries (see Tables 7 and 8).

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[20] Rolf J. Langhammer, *ASEAN Agricultural Exports to the EC: Discriminated by the ACP Trade Preferences or Not?*, paper presented at the conference on ASEAN-EEC Economic Relations, Brussels, 16-18 September 1982 (Singapore: Institute of Southeast Asian Studies, forthcoming).

[21] Harry G. Johnson, *Economic Policies Toward Less Developed Countries* (Washington, D.C.: Brookings Institution, 1977).

[22] Rolf J. Langhammer and Andre Sapir, *Economic Impact of Tariff Preferences*, paper presented at a research meeting convened by the Trade Policy Research Centre on Participation of Developing Countries in the International Trade System, Wiston House, Sussex, 22-25 October 1984. Forthcoming as Thames Essays.

Table 8: **Structure and Volume of EEC Imports from Hong Kong, Republic of Korea, Singapore and Taiwan, 1973-1981**

Item	GSP Beneficiaries			
	Hongkong	Korea, Rep. of	Singapore	Taiwan
EEC imports of semi-manufactures and manufactures, 1981 (EUA million)[a]	2,223.9	1,568.2	931.0	1,756.2
Average annual growth rate of EEC imports of semi-manufactures and manufactures, 1973-1981 (%)[a]	14.2	33.9	24.5	26.8
Structure of EEC imports by GSP categories, 1980 (share of sensitive and semi-sensitive goods, %)				
Sensitive semi-manufactures and manufactures	11.3	29.4	36.6	37.8
Sensitive textiles	44.0	33.7	12.3	0.1
Sensitive agricultural products	—	2.2	0.3	0.1
Semi-sensitive semi-manufactures and manufactures	16.2	15.5	17.6	27.4
Semi-sensitive textiles	0.8	0.9	0.1	—
Semi-sensitive agricultural products	—	1.0	—	—

— = nil.

a Excludes Greece, Portugal and Spain.

Note: EUA = European Units of Account.

Sources: Eurostat, Microfiche SPG 2441 (1980). Analytical Tables of Foreign Trade, NIMEXE (1973 and 1981).

The trend of Taiwan's exports to the EEC after 1981 reconfirms that denial of trade preferences need not necessarily hinder the growth of exports. During 1981-1984, Taiwan increased its exports of manufactured and semi-manufactured goods to the EEC by 15 per cent a year compared with 18 per cent for Singapore, 10 per cent for Hong Kong and 7 per cent for the Republic of Korea. The relatively weak impact of GSP on trade expansion is mainly due to three reasons. First, as indicated earlier, tariff barriers have become less important in absolute terms because of the GATT-negotiated tariff cuts and in relative terms because of the emergence of non-tariff measures. Second, especially in sophisticated products, price is only one determinant of competitiveness among other factors such as quality, punctual delivery, and adaptability to changing demand. Third, the administrative requirements such as direct shipment and local content of value added penalize countries that have become integrated into the international division of labor by assuring duty-free access to suppliers of high-quality intermediate inputs.[23] It is difficult, for example, for Southeast and East Asian developing countries to meet EEC local value added content requirements in garment production if fabrics are imported.

Table 9 shows that the share of GSP-covered EEC imports from 12 Asian countries which actually received preferential treatment declined from 39 per cent in 1978 to 33 per cent in 1984.[24] Low average rates of GSP utilization are mostly the result of restrictive controls on the origin of goods and tariff quotas against open and successful exporting countries such as Hong Kong and Singapore. The decline in utilization rates has been exclusively due to the increasing amount of GSP-covered imports from the leading exporter Hong Kong which was denied preferential treatment.

It is noteworthy that the GSP has not been uniformly practised by all EEC member countries. The Federal Republic of Germany and the United Kingdom, which accounted for 62 per cent of manufactured imports from the Asian countries in 1984, have in recent years resorted to a more rigid application of GSP restrictions. The smaller importers — the Benelux states, France and Italy — seem to have eased their former controls on GSP concessions. As a result, large differences between EEC countries in applying GSP regulations, which existed until the early 1980s and which reflected differences in lobbying power between traders and domestic producers in the member countries, seem to have narrowed.[25]

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[23] The duty-free access of many Asian garment industries to foreign intermediate inputs is considered a major advantage compared with similar Latin American industries. See David Morawetz, *Why the Emperor's New Clothes Are Not Made in Colombia: A Case-Study in Latin American and East Asian Manufactured Exports* (New York: Oxford University Press, 1981).

[24] Even if it is considered that GSP-covered items include some goods which can be imported duty-free under "most-favored-nation" conditions and which, therefore, should not be regarded as preference-receiving imports, and even if tariff quotas and ceilings are taken into account, such modifications do not fully explain relatively low GSP utilization rates.

[25] Ann Weston, Vincent Cable and Adrian Hewitt, *The EEC's Generalized System of Preferences: Evaluations and Recommendations for Change* (London: Overseas Development Institute, 1980).

Table 9: **Share of GSP-Receiving Imports in GSP-Covered Imports from Selected Asian Developing Countries, 1978 and 1984**

(Percentages)

EEC Country		Bangla-desh	China, People's Rep. of	Hong Kong	India	Indo-nesia	Korea, Rep. of	Malay-sia	Paki-stan	Philip-pines	Singa-pore	Sri Lanka	Thai-land	All Selected Countries
Benelux	1978	79	*	24	9	54	19	28	19	46	15	46	36	22
	1984	63	44	16	24	27	26	36	57	63	23	34	47	31
Denmark	1978	95	*	40	56	63	37	65	91	55	31	59	61	51
	1984	87	36	14	62	32	25	21	54	62	52	57	66	35
France	1978	14	*	41	32	43	28	20	59	16	13	35	46	30
	1984	54	33	34	44	37	32	23	63	47	27	30	62	37
Germany, Fed. Rep. of	1978	58	*	34	41	63	26	29	79	47	27	56	51	37
	1984	64	41	18	55	44	25	49	74	51	38	33	52	35
Greece	1984	68	16	12	32	41	24	35	37	33	32	47	45	24
Ireland	1978	2	*	51	55	9	29	26	24	31	29	78	63	38
	1984	—	14	19	82	40	14	18	39	32	30	30	24	24
Italy	1978	23	*	29	18	9	20	25	16	49	13	56	13	16
	1984	52	35	26	27	51	30	59	39	44	15	36	33	31
United Kingdom	1978	93	*	35	45	36	27	60	52	33	34	74	33	40
	1984	59	39	13	46	92	28	46	50	37	41	59	50	31
EEC Total	1978	67	*	33	29	40	25	38	58	40	23	56	40	39
	1984	60	38	17	43	50	27	42	58	48	33	40	51	33

— = nil.

* In 1978 the People's Republic of China was not yet a beneficiary of the EEC GSP scheme.

Notes: GSP-covered imports are all imports from a GSP beneficiary which lie in those tariff headings or subheadings included in the GSP. GSP-receiving imports are all GSP-covered imports which receive duty-free (or for some agricultural products duty-reduced) treatment.

Source: Eurostat, Microfiche SPG-2441 (1978 and 1984).

Table 9 also shows that for most of the Asian developing countries, the share of GSP-covered exports which actually received preferences increased over time. However, this does not imply that the good performance of Asian exporting countries could not have been achieved without preferences. Preferences, especially for products subject to tariff quotas and ceilings, seem at best equivalent to aid flows if tariff revenues forgone accrue to the exporters.[26] If quotas are allocated to established importers on a "first come, first served" basis, there is evidence that the transfer effect accrues primarily to the importer who receives the tariff revenues.[27] But even if the transfer is passed fully to Asian exporters by raising the export price by the amount of the preference margin, the transfer would still be very small. For example, with GSP-receiving imports from Asian developing countries amounting to European Currency Units (ECU) 4.5 billion in 1983 and a preference margin equal to the average most-favored-nation tariff rate of 7 per cent, the transfer would have amounted to ECU 315 million, representing only 2.3 per cent of the net inflow of public and publicly guaranteed external capital into Asian developing countries in 1983.

On the whole, GSP-covered trade comprises only part of the exports from Asian developing countries to the EEC of which about one-third enters duty-free.[28] Preferential tariffs in favor of developing countries associated with the EEC did not prevent them from losing markets to Asian developing countries.[29] Also, as indicated earlier, tariff discrimination in the case of Taiwan did not act as a major disincentive to the expansion of exports. In general, these results suggest that EEC trade preferences aimed at trade diversion and trade creation have largely failed.

Who Bears the Costs of Protection and Discrimination?

In the light of the rapid growth and diversification of exports in Asian developing countries over the past decade, compared with countries in other developing regions, it must be concluded that EEC protectionism has not obliterated the gains from earlier trade liberalization. However, more trade, particularly with Asian developing countries, would have been possible if the EEC

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[26] In general, the benefits of GSP accrue not only to consumers in the importing country, but also to the importers and exporters. However, consumers will not benefit if importers and exporters retain the preference margins. This would occur if importers keep the price to consumers unchanged after the introduction of preferences or if exporters raise the price by the amount of the preference margin. This income will accrue to importers in the former case and to exporters in the latter case. It is, however, more likely that the gains will be shared among consumers, exporters (who raise the export price by a part of the tariff reduction) and importers (who benefit from lower prices due to the tariff reduction). The distribution of income gains would depend on the elasticities of supply and demand and on the relative bargaining power of the exporters and importers.

[27] Rolf J. Langhammer and Andre Sapir, *op. cit.*

[28] For the 12 Asian countries in Table 9, for example, exports eligible for GSP treatment accounted for about 70 per cent of their total exports to the EEC in 1984.

[29] Jamuna P. Agarwal, Martin Dippl and Rolf J. Langhammer, *EC Trade Policies Towards Associated Developing Countries—Barriers to Success* (Tübingen: J.C.B. Mohr, 1985).

had not protected and segmented internal markets and penalized successful exporting countries instead of rewarding them.

The costs of protection and discrimination have been borne by EEC consumers and also by Asian producers and workers.[30] These costs, however, refer to only the initial effects of protection and discrimination. The secondary effects give rise to greater concern and relate to the implications for the allocation of resources in the EEC. If protected sectors absorb more resources than under conditions of open markets, export activities are discriminated against, and so are efforts to relocate productive capacities and to invest in developing countries. In contrast to the Japanese, European investors have preferred direct exports to foreign investment. They have given priority to investment in developed countries rather than in developing countries. Also, they have invested in developing countries with large domestic markets in order to cater to these markets behind protective walls, e.g., in Latin America. This attitude explains the relatively limited foreign direct investment by EEC countries in Asian developing countries.[31]

Apart from direct investment, other forms of division of labor between the EEC and Asian developing countries have also received relatively limited attention. For example, EEC-based manufacturers of clothing have focused their "external" processing on countries in Eastern Europe and North Africa. In 1983, imports of clothing by EEC countries under external processing from Eastern Europe accounted for 68 per cent of clothing imports from this region, compared with 5 per cent of such imports from Asian and Latin American developing countries. An expansion of activities such as in external processing and subcontracting would make both EEC importers and producers powerful lobbyists against EEC trade barriers.

The export of long-term private risk capital from EEC countries and further division of labor between EEC-based and Asian developing country-based firms would not only promote a two-way trade and encourage the transfer of technology, but also weaken protectionist tendencies. However, a major obstacle is the inward-looking and risk-averting attitude of many European investors. The costs of this sentiment are borne by both trading partners, perhaps to a greater extent by Europe itself.

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[30] Martin Wolf, Hans H. Glismann, Joseph Pelzman and Dean Spinanger, *Costs of Protection in Textiles and Clothing*, Thames Essay, no. 37 (London: Trade Policy Research Centre, 1984); and Dean Spinanger and Joachim Zietz, *Managing Trade but Mangling the Consumer: Reflections on the EEC's and West Germany's Experience with the MFA*, Kiel Working Papers, no. 245 (Kiel, November 1985).

[31] In 1983, about 27 per cent of the total foreign investment from Japan was in Asian developing countries, compared with 6 per cent for the United States and 2 per cent for the Federal Republic of Germany. See Martin Gross, *The Extent, Structure and Change of German, Japanese and U.S. Direct Investment in ASEAN Countries*, Kiel Working Papers, no. 239 (Kiel, August 1985), Table 1.

The Asian Development Bank is an international development finance institution owned by member governments. It was established in 1966 for the purpose of lending funds and providing technical assistance to developing member countries in the Asian and Pacific region, and for promoting investment and fostering economic growth in the region.

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